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<p>1 (10:00 a.m.)</p> <p>2 CHAIRMAN:</p> <p>3 Q. Okay. So if there are no -</p> <p>4 MS. GLYNN:</p> <p>5 Q. There are no preliminary matters, Mr. Chair.</p> <p>6 CHAIRMAN:</p> <p>7 Q. Sir, I think we are with you.</p> <p>8 KELLY, Q.C.:</p> <p>9 Q. Thank you, Mr. Chairman. Mr. Chairman,</p> <p>10 Commissioners, Newfoundland Power has filed a</p> <p>11 comprehensive written brief which effectively</p> <p>12 addresses all of the issues in this</p> <p>13 proceeding. That includes both the settled</p> <p>14 issues reflected in the settlement agreement</p> <p>15 and the issues which were dealt with in the</p> <p>16 hearing itself, primarily cost of capital and</p> <p>17 depreciation. So I thought what might be</p> <p>18 helpful as we start this morning was to try to</p> <p>19 put this proceeding, and specifically the cost</p> <p>20 of capital discussion, into a bit of a broader</p> <p>21 long-term context, and in considering that</p> <p>22 historical context, I wanted to look back at</p> <p>23 where we've come from, but then more</p> <p>24 importantly, to discuss where we're going in</p> <p>25 the future because this GRA comes at an</p>	<p>1 return matters both to the company and to its</p> <p>2 customers and during the course of his</p> <p>3 explanation, he commented on the fact that we</p> <p>4 have a generally supportive regulatory</p> <p>5 environment here in Newfoundland and he</p> <p>6 pointed out some differences with other</p> <p>7 jurisdictions such as the automatic flow</p> <p>8 through of storm damage that's over \$100,000</p> <p>9 in Alberta, but we don't have that here. And</p> <p>10 that led to an interesting question from you,</p> <p>11 Mr. Chairman, in which you asked Mr. Ludlow</p> <p>12 "what else do you think we could do to make</p> <p>13 the regulatory environment more than generally</p> <p>14 supportive?" Now that was an excellent</p> <p>15 question and one that I think helps focus the</p> <p>16 discussion I'd like to have this morning.</p> <p>17 Broadly speaking, from a financial</p> <p>18 perspective, two things are required in order</p> <p>19 to have least cost reliable power over the</p> <p>20 long term. One is appropriate capital</p> <p>21 expenditures and two is reasonable annual</p> <p>22 revenues, including the fair return, and you</p> <p>23 got to have both. Now with that comment,</p> <p>24 let's look back a bit and see how this has</p> <p>25 worked.</p>
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<p>1 important time in terms of the future of the</p> <p>2 development of the Province's electrical</p> <p>3 system. We've just come through a major</p> <p>4 public policy debate about the future of</p> <p>5 energy supply here in Newfoundland and</p> <p>6 Labrador. The decision has been made to</p> <p>7 proceed with Muskrat Falls and the Labrador</p> <p>8 Infeed with power supply now projected for</p> <p>9 2017 or shortly thereafter.</p> <p>10 Deciding to build Muskrat Falls and bring</p> <p>11 power to the island is one thing, but much</p> <p>12 still needs to be done over the next few years</p> <p>13 to ensure that this new source of supply is</p> <p>14 properly integrated into the island grid. We</p> <p>15 must ensure that there is an uninterrupted and</p> <p>16 seamless energy supply for Newfoundland Power</p> <p>17 customers. And getting that right is</p> <p>18 important for our customers, but it's also</p> <p>19 important for the Province and the provincial</p> <p>20 economy.</p> <p>21 Now Mr. Chairman, the principal issue in</p> <p>22 this proceeding is cost of capital and</p> <p>23 specifically the fair return on equity for</p> <p>24 Newfoundland Power. Mr. Ludlow, in his</p> <p>25 evidence, explained to you why having a fair</p>	<p>1 You heard Mr. Ludlow describe the cuts to</p> <p>2 both operating and capital expenditures</p> <p>3 following the cod moratorium in 1992. Those</p> <p>4 cuts were unfortunate but necessary. We had</p> <p>5 50,000 people leave the province and over</p> <p>6 time, those cuts affected the reliability of</p> <p>7 the electrical system. It's 1992.</p> <p>8 Then we come up to 1997. We had first</p> <p>9 oil in the province from Hibernia. It was</p> <p>10 time to get ready for the future. And I've</p> <p>11 been at this now about 15 years and I remember</p> <p>12 being here listening to the then president,</p> <p>13 Mr. Hughes, talking about the need to get our</p> <p>14 electrical system ready for the changing</p> <p>15 economy. And I was here with Mr. John Evans,</p> <p>16 who was then the vice-president of operation</p> <p>17 and engineering, and we brought down examples</p> <p>18 of rusted out pole transformers, corroded</p> <p>19 conductor and defective insulators so the</p> <p>20 Board could actually see hands on what the</p> <p>21 actual state of some of these assets were.</p> <p>22 And the Board's own consultant confirmed what</p> <p>23 we were saying. And the Board responded by</p> <p>24 then approving increased capital expenditures</p> <p>25 to improve and maintain system reliability.</p>

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<p>1 That was the time when Newfoundland Power 2 started to introduce the stainless steel 3 transformer tanks that you heard about in this 4 hearing in the last several weeks. And the 5 Board has continued to support Newfoundland 6 Power's capital program and today on our 7 system we have good reliability, bearing in 8 mind that we're on a rock in the North 9 Atlantic.</p> <p>10 But in addition to capital expenditures, 11 you also need reasonable annual revenues, 12 including a fair return on equity. And we 13 brought Dr. Moran here in the late 1990s who 14 explained to the Board that the least cost or 15 the optimum cost is achieved when the return 16 on equity and the capital structure results in 17 an A bond rating. That gives you the least 18 cost power over the long term. So, return and 19 capital structure are both important 20 components of getting least cost power.</p> <p>21 In the 1998/99 GRA, the Board cut 22 Newfoundland Power's return to what was then 23 the very low rate of nine and a quarter 24 percent. That was the lowest then allowed for 25 any investor-owned utility in North America.</p>	<p>1 course, one of the points out of that is 2 management has an obligation then to both 3 investors and to our customers to actually 4 earn those returns. Earning the comparable 5 return is what satisfies investors, satisfies 6 the credit rating agencies and ensures least 7 cost power. That's the point that Mr. Ludlow 8 was trying to make in this opening comments.</p> <p>9 So Mr. Chairman, if you then fast forward 10 through the decade from about 1998 to 2008, we 11 have a couple of things. During that period, 12 the Board adopted a formula to adjust the ROE 13 during a time when there was a long-term 14 sustained decline in long Canada bond yields. 15 Newfoundland Power actually proposed using the 16 formula and the Board adopted that formula at 17 that time over the objections of the then 18 Consumer Advocate, who advocated regular cost 19 of capital hearings. And the formula worked 20 reasonably well until 2008.</p> <p>21 The other thing that the Board did during 22 that ten-year period was they expanded the 23 range of rate of return. The rate is set at 24 the midpoint of the range, but the Board 25 expanded the allowed range. And that was done</p>
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<p>1 And one of the credit rating agencies then 2 reduced Newfoundland Power's credit rating. 3 So we had this anomaly that just as capital 4 expenditures were increasing, Newfoundland 5 Power's credit rating was eroded. And as you 6 know, money which is borrowed to fund capital 7 expenditures has to be repaid over a 30-year 8 period.</p> <p>9 So in 2003, the Board changed course and 10 increased Newfoundland Power's return to 9.75 11 percent. So the return on equity is a key 12 component of least cost power for customers 13 and of course, it goes without saying that the 14 return matters to equity investors. They 15 expect a return on equity which is equal to 16 the return on other comparable risk 17 investments or to put it slightly differently, 18 returns which are comparable to those earned 19 by other average risk utilities. And we know 20 that capital flows to higher returns. That's 21 the reason, for example, why FERC down in the 22 United States is now giving higher returns for 23 new transmission assets to encourage 24 investment in those previously underfunded 25 assets, the real problem in the US. And of</p>	<p>1 as an incentive for management to find 2 productivity improvements between GRAs. That 3 was in 2003. So the utility could increase 4 its earned return in the short run, but of 5 course, those savings flow back to customers 6 for their benefit at the next GRA. So just 7 like FERC in the United States, this Board 8 concluded that an ROE incentive was a good 9 thing, not just for the shareholders, but for 10 our customers.</p> <p>11 And then we come all the way up to 2008 12 and the world changed. The financial markets 13 crashed. Long Canada bond yields collapsed. 14 Credit spreads on utility bonds became 15 astronomical. The formulas weren't working 16 and many regulators at that stage, including 17 the NEB and the British Columbia Utilities 18 Commission, later followed by Alberta, 19 suspended or discontinued use of their formula 20 mechanisms. By the time we got to 21 Newfoundland Power's 2009 GRA, things had 22 settled down a bit, but there was still a huge 23 degree of uncertainty in financial markets and 24 where things were headed. You'll remember 25 that the long Canada bond yields for 2010 were</p>

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<p>1 forecast to be in the four and a quarter to 2 four and a half percent range, but at the time 3 of the hearing in 2009, they were still below 4 that range.</p> <p>5 Newfoundland Power and its expert, Ms. 6 McShane, pointed out the high degree of 7 uncertainty in the financial markets and 8 proposed discontinuing the use of the formula 9 and simply setting a rate of return until 10 markets returned to more normal conditions. 11 But Dr. Booth, however, was confidently 12 predicting that the worst was behind us; the 13 recovery was well under way and long Canada 14 bond yields would be five, five and a half, 15 six percent within a few years. That's the 16 discussion we had in 2009. In 2009, one thing 17 we can say is the general consensus was that 18 bond yields were going to be higher, not 19 lower. And so that put this Board in a rather 20 difficult position. You had to make a 21 difficult choice and in 2009 you decided to do 22 two things. One is you set the rate of return 23 at nine percent and two, you decided to keep 24 the formula.</p> <p>25 Now those two things are not separate and</p>	<p>1 been over ten percent in 2011.</p> <p>2 So the starting ROE and the formula 3 mechanism, these two things are very 4 interrelated and at that point in time, in 5 2009, everyone, including ourselves, were 6 thinking ROEs -- sorry, long Canada bond 7 yields would increase. And so that started us 8 off in 2010 with a sub par ROE, below the 9 Canadian average.</p> <p>10 (10:15 a.m.)</p> <p>11 Then just come through each of the years. 12 We get into 2010 and the first thing that 13 happens is we have the March ice storm and 14 Hurricane Igor and with careful and prudent 15 management and by deferring other 16 expenditures, the company managed to absorb 17 1.8 million in costs without having to come 18 back to the Board to ask for a cost deferral 19 order. That's not a bad thing. That's a good 20 thing. That's what you want your utility to 21 do, if possible. And Mr. Ludlow did caution 22 that that may not always be possible, 23 especially if you get it happening late in the 24 year and a cost deferral is necessary. Even 25 Dr. Booth was complimentary about the</p>
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<p>1 distinct. They are highly interrelated. At 2 nine percent, the ROE for 2010 was 3 approximately 30 basis points below the 4 average of other Canadian allowed utilities, 5 so 30 basis points lower than the average. 6 But we recognized you can't just look at nine 7 percent in isolation and we assumed the Board 8 didn't do that either. If you're going to 9 keep a formula, then you need to have some 10 sense of well, what happens if I look out over 11 the next couple of years with that formula 12 mechanism. And at the time, of course, the 13 Board was using a long Canada bond yield of 14 four and a half percent for 2010 and if you 15 took Dr. Booth's point where he was 16 confidently predicting we could be at, say 17 five and a half percent, then if you -- you 18 had to set the rate of return at a fairly low 19 rate to start off with, because look what 20 happens if you didn't. If you were at nine 21 percent and long Canada bond yields went up 22 one percent, then Newfoundland Power's ROE in 23 2011 would have been 9.8 percent. And if you 24 started at the average of Canadian utilities, 25 9.3, and it went up one percent, we would have</p>	<p>1 achievement and you may remember Mr. Ludlow 2 rather proudly pointing out that our trucks 3 headed home with the power back on passing the 4 Canadian Armed Forces coming in to help, on 5 their way in.</p> <p>6 With good management in 2010, the company 7 still managed to earn a return of 9.21 percent 8 for 2010, which was close to the average of 9 Canadian utilities. So that was 2010.</p> <p>10 Then we come up to 2011 and the world did 11 not unfold as we all thought it would. Long 12 Canada bond yields fell dramatically. The 13 formula cut Newfoundland Power's allowed ROE 14 to 8.38 percent, the lowest for any investor- 15 owned utility in North America in 2011. 16 Credit rating agencies didn't reduce the 17 company's bond rating, but they did flag up 18 that the reduced credit metrics, as a result 19 of the ROE reduction, and warned of a possible 20 downgrade if they perceived a meaningful 21 reduction in the level of regulatory support, 22 combined with weaker liquidity and a sustained 23 deterioration in Newfoundland Power's 24 financial metrics. And clearly, the rating 25 agencies were looking to see if this trend was</p>

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<p>1 going to continue and how it would play out.</p> <p>2 As Ms. Perry explained, in 2011 the</p> <p>3 company chose to try to manage that problem,</p> <p>4 especially since there was a great deal of</p> <p>5 uncertainty because of the Bell pole -- Bell</p> <p>6 Aliant pole transaction and the related</p> <p>7 financial effects of that, including the rate</p> <p>8 base impacts that it had. So a great deal of</p> <p>9 executive time and effort went into managing</p> <p>10 the financial affairs of the company in 2011,</p> <p>11 including managing the return. The company</p> <p>12 did achieve nine percent, which was not a bad</p> <p>13 result in the circumstances, but as 2011 went</p> <p>14 on, the financial crisis in Europe became full</p> <p>15 blown, the US economy struggled, US and France</p> <p>16 got downgraded and long Canada bond yields</p> <p>17 collapsed, just went through the floor. Even</p> <p>18 Dr. Booth admitted he didn't see it coming.</p> <p>19 Then if the formula would have applied in</p> <p>20 2012, it would have reduced Newfoundland</p> <p>21 Power's return to 7.85 percent, far below any</p> <p>22 other allowed return. That led to another</p> <p>23 huge expenditure of time and effort to manage</p> <p>24 the return. There was a cost of capital</p> <p>25 application filed with the Board. Experts</p>	<p>1 everyone loses, shareholders and customers,</p> <p>2 because the allowed return is merely the</p> <p>3 starting point. The lower the allowed return,</p> <p>4 the harder it is to earn a fair return, one</p> <p>5 that's comparable to the returns earned by</p> <p>6 other average risk utilities. And as Mr.</p> <p>7 Ludlow pointed out, you may be able to defer</p> <p>8 some expenditures in the short term, but you</p> <p>9 can't do that without adverse consequences</p> <p>10 over the long term. That's particularly true</p> <p>11 in this jurisdiction when we already ask our</p> <p>12 utility to manage unexpected events such as</p> <p>13 storm damage, if possible, rather than</p> <p>14 providing an automatic storm recovery</p> <p>15 mechanism.</p> <p>16 And that point is particularly important</p> <p>17 as we go forward because as I said at the</p> <p>18 beginning of my comments, the next several</p> <p>19 years are critical. Senior management needs</p> <p>20 to be focused on managing the electrical</p> <p>21 system, managing the transition from where we</p> <p>22 are today to where we must be in 2017-2018 and</p> <p>23 getting there requires a lot of work.</p> <p>24 Ultimately that new power generation source</p> <p>25 and those new transmission assets have got to</p>
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<p>1 were hired. We answered hundreds of RFIs.</p> <p>2 And ultimately there was a negotiated return</p> <p>3 of 8.8 percent and that 8.8 percent stabilized</p> <p>4 Newfoundland Power's financial metrics.</p> <p>5 That's the word Moody's pointed out, used and</p> <p>6 pointed out in its most recent credit ratings</p> <p>7 report. But that 8.8 percent was still 28</p> <p>8 basis points below the average of allowed</p> <p>9 Canadian utility returns for 2012 and you'll</p> <p>10 see that in an answer to a question by PUB</p> <p>11 staff at PUB-CA-023. And then we went through</p> <p>12 this 2013/14 GRA with more experts' reports</p> <p>13 and about a month of hearing time.</p> <p>14 So Mr. Chairman, Commissioners, there's</p> <p>15 some important lessons we think to be learned</p> <p>16 from the experience of the last several years.</p> <p>17 It's important to keep in mind that</p> <p>18 Newfoundland Power is a small utility charged</p> <p>19 with providing electrical service in a harsh</p> <p>20 environment. For most of the past three</p> <p>21 years, Newfoundland Power's small management</p> <p>22 team has spent a large amount of its time and</p> <p>23 effort managing the company's financial</p> <p>24 affairs and its return because unless the</p> <p>25 company actually earns a reasonable return,</p>	<p>1 feed seamlessly into Newfoundland Power's</p> <p>2 substations and its distribution system and</p> <p>3 that will require coordinated planning,</p> <p>4 implementation and execution by both</p> <p>5 Newfoundland Power and Newfoundland Hydro.</p> <p>6 Now that's the background.</p> <p>7 So what is Newfoundland Power asking the</p> <p>8 Board to do now? We're asking you to do two</p> <p>9 things. One is to set a fair and reasonable</p> <p>10 return for Newfoundland Power, that's the</p> <p>11 first one, and two, discontinue the use of the</p> <p>12 automatic adjustment formula until we know</p> <p>13 what this new financial order is going to look</p> <p>14 like somewhere out in the future, at which</p> <p>15 time then the Board can reassess the</p> <p>16 appropriateness of a formula mechanism. And</p> <p>17 I'd like to talk about those two points.</p> <p>18 The first, the fair return on equity.</p> <p>19 It's clear from the evidence that long Canada</p> <p>20 bond yields are now expected to be low for the</p> <p>21 next several years, through 2013, 2014 and</p> <p>22 2015, so low in fact that Dr. Booth felt it</p> <p>23 necessary to put a floor of 3.80 percent in</p> <p>24 his proposed formula. That's 1.2, 1.3 percent</p> <p>25 above where long Canada bond yields are today</p>

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<p>1 and it's above where Dr. Booth expects them to 2 be over the next several years. So there's no 3 imperative for a formula. The Board can, it 4 has the ability and so it can and should 5 simply determine a fair and reasonable ROE 6 which will be included in the test year costs 7 until further order of the Board. That's 8 essentially how the ROE was set and applied 9 from the time the Public Utilities Act came 10 into effect in the early 1950s all the way up 11 to 1998 in this province.</p> <p>12 In setting the return, the Board should 13 be mindful that Newfoundland Power's allowed 14 ROE's since the last GRA have been below par. 15 That was especially true in 2011, but it was 16 also true in 2010 and 2012. So the allowed 17 returns for those years are not the 18 appropriate benchmarks for the return that you 19 should set today.</p> <p>20 Now my friend, Mr. Johnson, the Consumer 21 Advocate, will say that the cost of equity has 22 come down and I'm sure he will say to you Ms. 23 McShane said so. But it hasn't come down from 24 nine percent. It's come down from what the 25 real cost of capital was in 2010. If you look</p>	<p>1 on the one hand and a utility's cost of equity 2 on the other. That's why regulators such as 3 the British Columbia Utilities Commission, the 4 Ontario Energy Board, the Alberta Utilities 5 Commission, have moved away from sole or 6 predominant reliance on the CAP-M methodology. 7 They increasingly rely on other methodologies, 8 in particular, the discounted cash flow or DCF 9 methodology. The lack of any clear and 10 predictable relationship between long Canada 11 bond yields and a utility's cost of equity, 12 for example, has forced Dr. Booth to make 13 several judgmental adjustments to his CAP-M 14 analysis as he tried to come up with a 15 reasonable result and Mr. MacDonald 16 acknowledged in his report that his CAP-M 17 analysis on a stand-alone basis would result 18 in a return which would not be a fair ROE for 19 the company.</p> <p>20 So the days of sole reliance on CAP-M are 21 over. Dr. Vander Weide went so far as to say 22 that its application is so distorted in 23 current financial market conditions that he 24 placed no weight on it. The use of multiple 25 methodologies, each of which has its own</p>
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<p>1 at allowed utility returns in Canada, the 2 average was 9.29 percent in 2010. It was 9.08 3 percent in 2012 and you'll find that 4 information in the response to the PUB staff 5 question PUB-CA-023 and find it in Ms. 6 McShane's Schedule 3, page two of two. And 7 the evidence of the cost of capital witnesses 8 was that the financial market conditions in 9 2013, 2014 will be no different than in 2012. 10 You'll find Dr. Booth's answer saying that at 11 PUB-CA-015.</p> <p>12 But looking at allowed utility returns is 13 admittedly circular, though it is a good 14 reasonableness check. So what other things 15 should you look at? Well, obviously the cost 16 of capital evidence itself. Mr. Chairman, 17 that evidence tells us that there have been 18 two important shifts in regulatory thinking 19 since we were here in 2009. The first is with 20 respect to the use of the CAP-M methodology.</p> <p>21 With the collapse of long Canada bond 22 yields, which are driven by government 23 monetary policy instead of market forces, 24 there's no longer any clear and predictable 25 relationship between long Canada bond yields</p>	<p>1 strengths and weaknesses, is to be preferred. 2 That was the approach of each of the other 3 cost of capital witnesses, except Dr. Booth. 4 That's how Ms. McShane approached it, Dr. 5 Vander Weide approached it, Mr. MacDonald 6 approached it. But even Dr. Booth did a DCF 7 analysis. His DCF analysis yielded 8.73 8 percent which when combined with 50 basis 9 points for floatation costs, would have given 10 a DCF result of 9.23 percent and Dr. Booth 11 himself acknowledged that he's now looking 12 more closely at DCF results and previously 13 what he used to do was apply 50 percent 14 weightings to DCF and his CAP-M results.</p> <p>15 Now the second change, because I told you 16 I think there are two changes in regulatory 17 thinking, the second change is with respect to 18 US comparisons in determining the fair return. 19 That's driven in part by increased reliance on 20 the DCF methodology because it's not possible 21 to construct a proxy group of Canadian 22 utilities to apply the DCF model. There are 23 only two publicly traded Canadian companies 24 that you could use. It is possible, however, 25 to construct a sample of US utilities, having</p>

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<p>1 comparable overall investment risk to 2 Newfoundland Power. Each cost of capital 3 witness did that, including Dr. Booth himself. 4 (10:30 a.m.) 5 Ms. McShane, you'll remember, explained 6 in detail how she narrowed her criteria for 7 the sample to satisfy the concerns that his 8 Board expressed in its last order and Dr. 9 Vander Weide and Mr. MacDonald each 10 constructed their own samples of US proxy 11 samples. And Dr. Booth's US sample included 12 six utilities, all but one of which were in 13 Ms. McShane's sample. So the testimony of all 14 of the witnesses provides a strong evidentiary 15 basis for the application of the DCF 16 methodology to a proxy group of US utilities 17 having overall comparable risk to that of 18 Newfoundland Power. 19 In 2009, the National Energy Board 20 expressly recognized that the integration of 21 Canadian and US financial markets make US 22 comparisons informative for determining a fair 23 return and if you look at what British 24 Columbia, Ontario and the Alberta Commissions 25 have done in their last decisions, they now</p>	<p>1 formula for all time. The Board can 2 reconsider the issue in the future. Over 3 time, a regulatory consensus will emerge, but 4 for the time being, simply setting a 5 reasonable rate of return for Newfoundland 6 Power is the best approach and then either 7 Newfoundland Power or the Board can initiate a 8 cost of capital review if market conditions 9 change. That approach gets us out of the 10 constant review of cost of capital that has 11 occurred since the financial crisis in 2008 12 and which has occupied so much time and 13 effort. 14 No witnesses come here, Mr. Chairman, to 15 suggest that a formula is actually necessary. 16 Dr. Booth testified that he only proposed a 17 formula because he was asked to. And Mr. 18 MacDonald agreed that one of the alternatives 19 that the Board should consider is simply 20 setting the rate of return with either party 21 can come back and apply to change it, if 22 needed. The two formulas proposed by Dr. 23 Booth and Mr. MacDonald demonstrate the lack 24 of any consensus as to how a formula should 25 operate.</p>
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<p>1 all consider US-based DCF results in informing 2 their views of appropriate returns for their 3 utilities. 4 In Newfoundland Power's written 5 memorandum, we have provided a useful table 6 which summarize the ROE results of the various 7 tests employed by each of the cost of capital 8 witnesses and we did that as a useful 9 assistance for the Board as a summary of all 10 the evidence. 11 So with that, I'd like to turn to talk a 12 little bit about the automatic adjustment 13 formula and I've already said most of what 14 needs to be said about that point. At this 15 point in time, we believe the best approach is 16 to discontinue the use of the formula until 17 such time as we know what this new economic 18 world order is going to look like. It is 19 clear that for at least the next three years, 20 we are going to be in a continuing period of 21 low long Canada bond yields as a result of 22 government monetary policy. 23 I do want to say that by proposing 24 discontinuance of the formula, Newfoundland 25 Power is not saying the Board should abandon a</p>	<p>1 The two formulas can have diametrically 2 opposite effects, depending upon the financial 3 circumstances. With a floor under long Canada 4 bond yields in Dr. Booth's formula, you could 5 actually reduce Newfoundland Power's return if 6 long Canada bond yields rise but utility 7 spreads contract, because unless you get over 8 his floor, even though long Canada bond yields 9 go up, Newfoundland Power's return could go 10 down because of the contraction of the credit 11 spread. Mr. MacDonald's formula in those 12 circumstances would yield the exact opposite 13 result. And as Ms. Perry demonstrated, Mr. 14 MacDonald's formula is unbalanced. A six 15 basis point reduction in long Canada bond 16 yields would reduce Newfoundland Power's ROE 17 by a quarter of a percent, 25 basis points. 18 While a 75 basis point increase in long Canada 19 bond yields would result in no increase to 20 Newfoundland Power's return. The proposed 21 formula has a 23 basis point built-in downward 22 bias because of how it's constructed. 23 The lack of a consensus over automatic 24 adjustment formulas arises because there's no 25 longer any clear and predictable relationship</p>

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<p>1 between long Canada bond yields and a 2 utility's cost of equity. The attempts in 3 this hearing to create a formula proxy for a 4 utility's cost of equity have resulted in 5 proposals which are complicated and uncertain. 6 The proposed formulas not only incorporate 7 utility bond credit spreads, but they've also 8 added floors and deadbands and automatic 9 triggers. There's no principal basis for us 10 to conclude that such mechanisms will 11 correctly establish the cost of equity for 12 Newfoundland Power.</p> <p>13 And it's interesting that the proposed 14 formulas are each variations of or have 15 similarities with the Ontario Energy Board's 16 2009 formula. Now the OEB needs a formula 17 mechanism because of the very large number of 18 small utilities that they regulate -- that it 19 regulates. But that's not true in 20 Newfoundland and Labrador. And it's 21 interesting, proponents of formulas now 22 suggest that the Ontario Energy Board formula 23 is yielding reasonable results, but they 24 ignore the fact that today's Ontario Energy 25 Board formula results stem from the fact that</p>	<p>1 time.</p> <p>2 Let me next say a few words about capital 3 structure. Newfoundland Power's 45 percent 4 equity component in its capital structure has 5 repeatedly been affirmed by this Board. It is 6 an important component of Newfoundland Power's 7 overall average risk profile, bearing in mind 8 the company's small size, hostile environment 9 and relatively weak customer and employee 10 demographics. Two additional considerations 11 have emerged since 2008 supporting the need 12 for the 45 percent equity in Newfoundland 13 Power's capital structure.</p> <p>14 The first is the fallout from the 15 financial crisis. Other regulators, such as 16 the British Columbia Utilities Commission and 17 the Alberta Utilities Commission, have moved 18 to strengthen their utilities' capital 19 structures over the past several years. 20 They've actually increased their equity 21 ratios. And that, of course, was in line with 22 the move to strengthen capital structures of 23 financial institutions in the wake of the 24 financial crisis because today, no country or 25 business is immune from scrutiny by the credit</p>
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<p>1 the Ontario Board set the starting return at 2 nine and three-quarters percent for 2010, one 3 of the higher allowed ROEs in the country at 4 that time. If you start high enough, yeah, 5 it'll give you nice results now, but nobody 6 was here at Newfoundland Power's last GRA, not 7 the Consumer Advocate, recommending that this 8 Board adopt an Ontario type formula starting 9 at nine and three-quarters percent.</p> <p>10 Most importantly, Mr. Chairman, at this 11 point in time, it's important that 12 Newfoundland Power's senior management team 13 focus their time and energy on the Province's 14 utility system. The certainty of a known 15 return which is fair and reasonable is 16 preferable to the uncertainty of what a 17 formula may or may not do in a world of 18 uncertain financial markets which are driven 19 by government monetary policy rather than 20 normal market forces.</p> <p>21 So Newfoundland Power, as I said earlier, 22 asks the Board to do two things: set a fair 23 and reasonable return; and then, two, 24 discontinue the use of the formula until it 25 can be reconsidered at some future point in</p>	<p>1 rating agencies, more from a potential of a 2 credit downgrade. We've seen that with the 3 United States, France and most recently, 4 Canadian banks. Mr. MacDonald specifically 5 referred to the factor of the continuing 6 fallout from the financial crisis in support 7 of his recommendation to maintain Newfoundland 8 Power's existing capital structure. That was 9 in his testimony on January the 18th at pages 10 245 to 247.</p> <p>11 The second factor was referred to by Mr. 12 Ludlow in his evidence and interestingly, 13 explicitly referred to by Moody's in their 14 most recent credit report. Moody's expressed 15 a cautionary note related to their concern 16 that Newfoundland Power's future ability to 17 fully recover costs and earn returns may be 18 compromised as the Province of Newfoundland 19 and Labrador undertakes development of the 20 Muskrat Falls hydro-electric project on the 21 Lower Churchill River and the related 22 transmission infrastructure. That's the 23 concern expressed by Moody's. And how credit 24 rating agencies view Newfoundland Power's risk 25 is obviously critical to maintaining</p>

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<p>1 Newfoundland Power's credit rating and</p> <p>2 ensuring least cost supply of power to</p> <p>3 customers.</p> <p>4 And as I noted at the beginning of my</p> <p>5 comments, changes in credit ratings affect</p> <p>6 borrowing costs and the cost of power over the</p> <p>7 long term. Over the next several years, it's</p> <p>8 particularly important that credit ratings not</p> <p>9 be jeopardized. So at this critical juncture,</p> <p>10 it is important that the Board demonstrate its</p> <p>11 commitment to continued regulatory support.</p> <p>12 An ill-conceived precipitous move to reduce</p> <p>13 the equity component of Newfoundland Power's</p> <p>14 capital structure, as proposed by Dr. Booth,</p> <p>15 could well have serious adverse effects for</p> <p>16 the company, its customers and the Province.</p> <p>17 The Board staff asked an interesting</p> <p>18 question of Dr. Booth in PUB-CA-015. They</p> <p>19 pointed out that Dr. Booth had not recommended</p> <p>20 a change in capital structure in his May 2012</p> <p>21 report and they asked if there had been any</p> <p>22 change in capital market conditions since that</p> <p>23 time. And Dr. Booth confirmed that there had</p> <p>24 not been any such changes since his May 2012</p> <p>25 capital structure recommendation, which was to</p>	<p>1 the transcript on January 15th, 2013, page 70,</p> <p>2 line 17.</p> <p>3 So Mr. Chairman, Commissioners, those are</p> <p>4 my comments on cost of capital. I intend to</p> <p>5 say a few words on depreciation.</p> <p>6 (10:45 a.m.)</p> <p>7 It's demonstrably true that the Board</p> <p>8 made the correct decision in 1983 when it</p> <p>9 directed Newfoundland Power to use the equal</p> <p>10 life group or ELG depreciation procedure.</p> <p>11 That is clear beyond a doubt. ELG is a</p> <p>12 recognized sound public utility practice in</p> <p>13 Canada. It best matches the expense with the</p> <p>14 life of the utility assets. It also ensures</p> <p>15 the fulfilment of the power policy requirement</p> <p>16 of least cost power consistent with</p> <p>17 reliability over the long term. Customer</p> <p>18 rates today are 3.7 million dollars less</p> <p>19 annually because of the Board's decision to</p> <p>20 adopt ELG. That's because Newfoundland</p> <p>21 Power's rate base is 70 million dollars less</p> <p>22 than if we had stayed on the ALG, average life</p> <p>23 group, procedure. If we were to revert to ALG</p> <p>24 after a relatively short time period customer</p> <p>25 rates would again be higher because of the</p>
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<p>1 leave it at 45 percent.</p> <p>2 In addition, there are real and practical</p> <p>3 difficulties with the suggestion that common</p> <p>4 equity be replaced by preference shares, and</p> <p>5 I'm not going to go through them all. I</p> <p>6 simply note that as Ms. Perry explained, the</p> <p>7 only realistic way to reduce the equity</p> <p>8 component to 40 percent would be to borrow 42</p> <p>9 million dollars in additional debt. That</p> <p>10 would put significant downward pressure on</p> <p>11 Newfoundland Power's credit metrics at a time</p> <p>12 when Moody's is looking for those credit</p> <p>13 metrics to be stabilized. That's the word</p> <p>14 they use.</p> <p>15 Finally, Mr. Chairman, on capital</p> <p>16 structure, a note of caution when you're</p> <p>17 reading the Consumer Advocate's brief. In his</p> <p>18 brief, the Consumer Advocate stated that</p> <p>19 Fortis had issued preferred shares in November</p> <p>20 2012 at 3.8 percent. That rate is not</p> <p>21 correct. The correct yield was 4.75 percent.</p> <p>22 I think it's just a mistake. The Consumer</p> <p>23 Advocate put the correct yield to Ms. Perry in</p> <p>24 cross-examination and she confirmed 4.75</p> <p>25 percent. You'll find that, if necessary, in</p>	<p>1 growth in the rate base. So that proposal is</p> <p>2 not in accordance with the power policy</p> <p>3 contained in the Electrical Power Control Act.</p> <p>4 Frankly, it is tantamount to saying let us</p> <p>5 take a benefit today that our parents paid for</p> <p>6 and let us pass the cost on to our children</p> <p>7 and our grandchildren.</p> <p>8 The company's depreciation expense is</p> <p>9 reasonable and prudent. Of the seven most</p> <p>10 property categories considered by Mr. Pous,</p> <p>11 Gannet Fleming had proposed increased in</p> <p>12 service lives for all of them. Their</p> <p>13 recommendation is supported by years of</p> <p>14 experience with Newfoundland Power's system,</p> <p>15 with site visits and with discussion with</p> <p>16 Newfoundland Power's engineering staff.</p> <p>17 Similarly, Gannet Fleming's recommendation</p> <p>18 with respect to net salvage estimate for</p> <p>19 overhead services is reasonable. There is</p> <p>20 simply no basis to conclude that any of the</p> <p>21 Gannet Fleming recommendations with respect to</p> <p>22 depreciation are either unreasonable or</p> <p>23 imprudent and that's the test that you would</p> <p>24 have to meet.</p> <p>25 Mr. Chairman, Commissioners, next I want</p>



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<p>1 to address three points that the Consumer 2 Advocate raised in his brief with respect to 3 operating costs. Those are drug costs, 4 retiring allowances and short term incentive 5 pay. I'll be relatively brief on each of them 6 and just ensuring that you have the 7 appropriate references if you need to in the 8 record.</p> <p>9 The Consumer Advocate didn't call any 10 evidence on these matters. The evidence in 11 the record does not support his assertions and 12 conclusions. Rather, the evidence 13 demonstrates that each of these forecast costs 14 is based upon the best information available. 15 Grant Thornton conducted a comprehensive 16 review of Newfoundland Power's operating 17 costs, including these items, and found 18 nothing unreasonable. There is no basis for 19 the Board to conclude that any of these 20 particular estimates of test year costs are 21 unreasonable or imprudent.</p> <p>22 First, on drug costs. The Consumer 23 Advocate asserts that OPEB expense should be 24 reduced because he speculates that drug costs 25 will be less than forecast. There's no basis</p>	<p>1 conclude that the forecast expense is 2 unreasonable and imprudent.</p> <p>3 With respect to retiring allowances, the 4 Consumer Advocate asserts that retiring 5 allowances for new non-unionized employees 6 should be disallowed. The point was addressed 7 by Mr. Smith in cross-examination on January 8 25th, page 32, line 8 through page 48, line 6. 9 Mr. Smith pointed out that retiring allowances 10 had been part of Newfoundland Power's 11 compensation package for many years, both for 12 unionized and non-unionized employees. 13 Newfoundland Power is currently addressing an 14 important demographic transition in its 15 workforce. He testified the company wants to 16 hire better than average employees and to do 17 so, must pay competitive compensation.</p> <p>18 The Consumer Advocate's brief refers to 19 proposed changes in New Brunswick and the 20 Federal civil services. These developments 21 were not introduced in evidence or explored 22 during the hearing and they certainly do not 23 represent any evidence, let alone any clear 24 evidence, of changes in retiring allowances in 25 Newfoundland and Labrador. But keep in mind,</p>
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<p>1 in the evidence for that conclusion. The 2 point was addressed by Ms. Perry in cross- 3 examination. You'll find the evidence January 4 15th, page 133, line 3 and it carries through 5 to page 141, line 13, and also on January 16 6 beginning at page 9, line 2, going through to 7 page 17, line 23.</p> <p>8 And succinctly summarized, Ms. Perry made 9 the following observations: Newfoundland 10 Power followed the usual process of 11 forecasting drug costs based upon the health 12 care trend numbers provided by Mercers. 13 Mercers said the effect of the new drug 14 regulation was impractical to quantify at this 15 point in time. Overall drug costs depend not 16 only on price but also drug usage. Further, 17 Newfoundland Power already has pricing 18 agreements with pharmacies through Blue Cross 19 which provide better prices than current on 20 drugs. And the forecast drug costs are based 21 upon the best information currently available.</p> <p>22 The Consumer Advocate's assertion that a 23 six percent cost reduction will occur is 24 unfounded speculation without any evidentiary 25 basis. It is no basis for this Board to</p>	<p>1 retiring allowances are one part of a total 2 compensation package. Changing any one 3 component necessarily requires adjustment to 4 other components to ensure that the total 5 compensation package remains competitive and 6 you must be competitive, especially in today's 7 environment. So there is simply no basis to 8 conclude that the test year estimate of costs 9 for labour overall is unreasonable or 10 imprudent.</p> <p>11 And the third point is the STI or short 12 term incentive plan. If I follow the brief 13 correctly, the Consumer Advocate's primary 14 focus appears to be with respect to the 15 earnings related component of the short term 16 incentive plan. His basis argument seems to 17 be that earnings benefit shareholders not 18 customers and I say in response, put simply, 19 that's nonsense. As I discussed earlier, 20 management has an obligation both to its 21 shareholders and to its customers to work hard 22 to earn comparable returns. Unless the 23 utility actually earns a fair return, credit 24 metrics deteriorate, bond ratings are 25 jeopardized, borrowing costs potentially</p>

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<p>1 increase and customers suffer. The Electrical 2 Power Control Act makes it clear that 3 maintaining a sound credit rating is an 4 important objective.</p> <p>5 The Consumer Advocate called no evidence 6 with respect to executive compensation. 7 Executive compensation was fully explored in 8 the last GRA and the Board accepted the expert 9 testimony of Mr. Karl Aboud. In this hearing, 10 the importance of earnings for customers was 11 fully set out in the response to CA-NP-452. 12 Mr. Ludlow dealt with it in his direct 13 testimony and in his cross-examination. In 14 his brief, the Consumer Advocate conveniently 15 left out Mr. Ludlow's answer referring to the 16 need for a balance between investors and 17 customers. And Ms. Perry dealt with the 18 testimony -- dealt with the issue in her 19 testimony on January 15th, which you'll find 20 at page 1, lines 18 through to page 6, line 21 16. And finally, in CA-NP-612, you'll see 22 that STI earning incentives have been included 23 in Newfoundland Power's cost of service since 24 at least 1977.</p> <p>25 The Consumer Advocate refers to decisions</p>	<p>1 returns. Earnings are important for both 2 investors and customers.</p> <p>3 Finally, Mr. Chairman, the last point I 4 should touch on very briefly is the 5 conservation plan. You'll note that the plan 6 itself provides mechanisms for ongoing 7 evaluation and consultation with industry and 8 market participants, no new or additional 9 process is required. Progress is being made 10 with respect to conservation. This is an 11 evolving program. The new program has an 12 expanded portfolio of options for customers. 13 But I want to make it clear, nothing limits 14 the number of customers who may want to take 15 advantage of the insulation option. That 16 option remains open for existing homeowners, 17 but the expanded portfolio gives customers 18 additional opportunities to achieve savings on 19 their electricity costs.</p> <p>20 Mr. Chairman, Mr. Adams gave an 21 interesting presentation with respect to mini- 22 split heat pumps. Newfoundland Power 23 personnel have spoken with Mr. Adams and will 24 be following up with him further. Those heat 25 pumps will be evaluated by the utilities. Mr.</p>
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<p>1 from Alberta and the Northwest Territories. 2 These weren't referred to or examined during 3 the evidence, but you will note in CA-NP-612 4 that financial performance is a factor in 5 executive compensation in British Columbia, 6 Alberta, Prince Edward Island and of course, 7 Newfoundland and Labrador.</p> <p>8 But before I leave this, there's an 9 interesting observation that Dr. Booth made 10 and I'd like to take you to this. It's on 11 January 18th, page 19, lines 8 to 19. And 12 here's what Dr. Booth had to say about good 13 management and earning the return. The 14 question I put to him "but in order to earn 15 the return, amongst the factors you mentioned 16 is also good management?" and his answer 17 "that's absolutely correct. If you look at 18 this and you have hopelessly incompetent 19 management that keeps making mistakes, then 20 you would get unstable earnings and then 21 you're in a paradox to then give the equity 22 holders a higher rate of return because they 23 hired incompetent managers." Dr. Booth 24 obviously sees the paradox that results if 25 management does not actually earn appropriate</p>	<p>1 Adams did note himself, he made a reference to 2 Newfoundland Hydro doing an evaluation during 3 his testimony. However, heat pumps have 4 significant capital cost, as well as ongoing 5 expense. So the cost benefit analysis must be 6 considered over the long term and evaluated in 7 light of energy supply costs and potential 8 system savings. With a decision to proceed 9 with Muskrat Falls, a hydro-electric project, 10 a proper cost benefit analysis necessarily 11 requires information on energy supply costs 12 and the quantification of potential savings 13 which is not currently available because 14 potential savings will be different when the 15 Holyrood thermal plant is effectively replaced 16 by hydro power. However, Newfoundland Power 17 and Newfoundland Hydro will be assessing this 18 technology and its potential costs and system 19 benefits as part of its continuing evaluation 20 of conservation opportunities.</p> <p>21 Mr. Chairman, Commissioners, those are my 22 submissions and comments, unless you have any 23 questions.</p> <p>24 CHAIRMAN: 25 Q. So I guess we'll break for 15 minutes?</p>

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<p>1 MS. GLYNN:</p> <p>2 Q. 15 minutes, please, Mr. Chair.</p> <p>3 CHAIRMAN:</p> <p>4 Q. 15.</p> <p>5 (BREAK - 10:59 a.m.)</p> <p>6 (RESUME - 11:18 a.m.)</p> <p>7 CHAIRMAN:</p> <p>8 Q. So I think, Mr. Johnson, we're over to you,</p> <p>9 sir.</p> <p>10 MR. JOHNSON:</p> <p>11 Q. Thank you, Mr. Chairman, Commissioners. I</p> <p>12 recently reread the final argument that Mr.</p> <p>13 Kelly made on behalf of Newfoundland Power</p> <p>14 back in 2009 and at that time, he put certain</p> <p>15 propositions to the Board. He said that the</p> <p>16 propositions would be of considerable</p> <p>17 assistance to the Board in its deliberations</p> <p>18 on the cost of capital. The proposition at</p> <p>19 the time was that the cost of equity was going</p> <p>20 to be higher in 2010. He said it would be up,</p> <p>21 not down, and he said the position -- that</p> <p>22 proposition was really incontrovertible and he</p> <p>23 referred at the time to how the spread over</p> <p>24 the long Canada had risen to 275 basis points</p> <p>25 in the spring of 2009 at the time of the</p>	<p>1 8.80 percent is not far off the nine percent</p> <p>2 order for 2010. And here we now have Canadian</p> <p>3 utilities, including members of the Fortis</p> <p>4 family, now borrowing 40 and sometimes 50 year</p> <p>5 debt at incredibly low interest rates. And as</p> <p>6 for the dividend yield, when Ms. McShane wrote</p> <p>7 her expert report in 2009, it stood at 4.2</p> <p>8 percent. Now it's down to about three</p> <p>9 percent, evidencing a declining trend in the</p> <p>10 cost of equity.</p> <p>11 As for the TSX price index, well, in</p> <p>12 March of 2009, just before Ms. McShane wrote</p> <p>13 her report, it was 7500 at its lowest, 8600 by</p> <p>14 the end of March. By October of 2009, when we</p> <p>15 were in hearings, the TSX price index stood at</p> <p>16 around 10,900. By July 2012, it was 11,600.</p> <p>17 By January 2013, it was 12,600.</p> <p>18 Now the Board will recall in this case</p> <p>19 that Ms. McShane said that she prepared her</p> <p>20 2009 report, and these are her words, "around</p> <p>21 the time of the worst part of the crisis."</p> <p>22 But she testified as well that things had</p> <p>23 changed considerably over the course of that</p> <p>24 year. She testified that by the time the</p> <p>25 hearing took place, there had been</p>
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<p>1 company's last bond issue and he pointed out</p> <p>2 that though the bond spreads had fallen by the</p> <p>3 time of the hearing, it was clear that debt</p> <p>4 investors required increased returns relative</p> <p>5 to long Canada bond yields and he noted that</p> <p>6 with the cost of fully secured debt having</p> <p>7 increased, it was simply not logical to</p> <p>8 believe that the cost of the unsecured equity</p> <p>9 investment had fallen. He said that the share</p> <p>10 prices had dropped as a result of the economic</p> <p>11 turmoil and as the share prices fell, the</p> <p>12 dividend yield rose in relation to the share</p> <p>13 price. The equity markets were thus</p> <p>14 signalling, he said, a rising cost of equity,</p> <p>15 just as the bond market was signalling a</p> <p>16 rising cost of debt. The proposition,</p> <p>17 according to Mr. Kelly, was inescapable that</p> <p>18 the cost of equity in 2010 was going up.</p> <p>19 Now given that this was such a key</p> <p>20 proposition last time, I would have expected</p> <p>21 Newfoundland Power to be now giving you, as</p> <p>22 its first inescapable proposition, the fact</p> <p>23 that the cost of equity is going to be lower</p> <p>24 in 2013 than what it is presently set at in</p> <p>25 rates in 2012. Because after all, the present</p>	<p>1 considerable improvement in market conditions.</p> <p>2 But she admitted that these improvements were</p> <p>3 not reflected in her recommended ROE because</p> <p>4 her cost of equity tests were not sensitive to</p> <p>5 the changing conditions. That's the reason</p> <p>6 why there was no change in her recommendation.</p> <p>7 Now in this case, Ms. McShane states that</p> <p>8 relative to late 2009, the cost of equity,</p> <p>9 according to the application of her various</p> <p>10 tests is 50 basis points lower. But you have</p> <p>11 to keep in mind that she is using pretty much</p> <p>12 the same tests in this GRA as she used the</p> <p>13 last time, albeit this time, we note that</p> <p>14 somehow she has managed to double the</p> <p>15 floatation allowance.</p> <p>16 Now Mr. Kelly, in 2009, also provided the</p> <p>17 Board with a second proposition and the second</p> <p>18 proposition was that the maintenance of credit</p> <p>19 worthiness for Newfoundland Power required a</p> <p>20 return of between nine and a half and nine and</p> <p>21 three-quarters percent. Now they were seeking</p> <p>22 11 percent, but between nine and a half and</p> <p>23 nine and three-quarters, he put that, that was</p> <p>24 the floor below which the company would not</p> <p>25 maintain credit worthiness and it would not be</p>

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<p>1 ensured that the company would be able to</p> <p>2 issue further debt to maintain service to its</p> <p>3 customers as required.</p> <p>4 Now with all due respect, the evidence in</p> <p>5 this case clearly establishes that</p> <p>6 Newfoundland Power overstated the return on</p> <p>7 equity that it required to maintain credit</p> <p>8 worthiness and to ensure that the company was</p> <p>9 able to issue further debt to maintain service</p> <p>10 to its customers. They've had financial</p> <p>11 integrity ever since the last GRA and they</p> <p>12 didn't require nine and a half or nine and</p> <p>13 three-quarters to get that. Both Mr. Ludlow</p> <p>14 and Ms. Perry confirmed that the company has</p> <p>15 had financial integrity since the last general</p> <p>16 rate application. Keep in mind as well that</p> <p>17 the Board's financial consultant's report</p> <p>18 shows that even if Newfoundland Power received</p> <p>19 no rate relief in either 2013 and 2014, they</p> <p>20 would still be meeting their credit metrics.</p> <p>21 Now this Board has heard from four</p> <p>22 witnesses on the cost of capital related</p> <p>23 issues and with due respect to each of the</p> <p>24 witnesses who testified, we submit that the</p> <p>25 witness who provided this Board with the most</p>	<p>1 withdraw some of that monetary policy</p> <p>2 stimulus; that we have a financial system</p> <p>3 that's firing on all cylinders. That's the</p> <p>4 Governor's words and Dr. Booth refers to</p> <p>5 Governor Carney's statement that there are</p> <p>6 relatively few places in the advanced world</p> <p>7 that investors can put their money with a</p> <p>8 degree of certainty that something</p> <p>9 catastrophic is not going to happen. Canada</p> <p>10 is one of those countries.</p> <p>11 Dr. Booth's report goes on to forecast</p> <p>12 the long Canada bond yield and he discusses</p> <p>13 the US situation and the fact that the United</p> <p>14 States has yet to take its fiscal medicine, as</p> <p>15 he puts it. He goes on to address the state</p> <p>16 of the corporate bond market and the state of</p> <p>17 capital markets generally. He refers</p> <p>18 specifically to the Federal Reserve of Kansas</p> <p>19 City and the financial stress index and he</p> <p>20 discusses how the researchers at the Bank of</p> <p>21 Canada who were actually the pioneers in</p> <p>22 developing a financial condition stress index,</p> <p>23 their index is reflecting relatively easy</p> <p>24 stress free capital market conditions.</p> <p>25 He discusses the state of equity markets</p>
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<p>1 in-depth analysis and explanation of capital</p> <p>2 market conditions was Dr. Booth.</p> <p>3 Dr. Booth addresses the financial and</p> <p>4 economic outlook in his report as a first and</p> <p>5 foremost issue. He starts his discussion by</p> <p>6 considering the capital market conditions. He</p> <p>7 discusses the outlook for inflation. He looks</p> <p>8 at the recent history of the long Canada bond</p> <p>9 yield. He describes a situation with the</p> <p>10 Eurozone and the sovereign debt issues of the</p> <p>11 US. He addresses the wrangling in Congress</p> <p>12 about the debt ceiling and the heavy lifting</p> <p>13 that Congress left to the Fed and details the</p> <p>14 massive intervention of the Fed through the</p> <p>15 Operation Twist. He discusses how policy</p> <p>16 makers in most other major economies are</p> <p>17 looking for ways to stimulate their economies</p> <p>18 further amid the European debt crisis and he</p> <p>19 noted Governor Carney's recent comments that</p> <p>20 Canada is in a very different place. Dr.</p> <p>21 Booth quotes Governor Carney as stating that</p> <p>22 our economy is almost back at full capacity,</p> <p>23 that the labour market has been growing, that</p> <p>24 we're growing above trend and the extent to</p> <p>25 which we continue to grow above trend, we may</p>	<p>1 during and after the financial crisis and how</p> <p>2 the state of the economy affects profits in</p> <p>3 the capital market. He discusses how</p> <p>4 profitability data has implications for the</p> <p>5 fair ROE. Dr. Booth concludes that the</p> <p>6 overall Canadian economy is in good shape and</p> <p>7 the financial system is firing at all</p> <p>8 cylinders. The stock market is valuing</p> <p>9 utilities favourably. Credit is easy.</p> <p>10 Utilities are issuing 40 and 50 year debt at</p> <p>11 very low rates. The only problem, as Dr.</p> <p>12 Booth puts it, is that as one of the very few</p> <p>13 AAA rated issuers left in the world, the</p> <p>14 Government of Canada is borrowing at extremely</p> <p>15 low interest rates, significantly lower than</p> <p>16 the US government. However this does not,</p> <p>17 according to Dr. Booth, indicate any</p> <p>18 heightened risk aversion in the credit</p> <p>19 markets.</p> <p>20 Dr. Booth in full spends about 35 pages</p> <p>21 of his report bringing this Board through the</p> <p>22 state of the capital markets, and I will put</p> <p>23 it to you that it is Dr. Booth who can speak</p> <p>24 of these matters with the most authority in</p> <p>25 this proceeding. You can search high and you</p>

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<p>1 can search low in Dr. Vander Weide's report 2 for discussion of capital market conditions, 3 but you won't find it.</p> <p>4 Ms. McShane discusses capital market 5 conditions, but the thing with Ms. McShane is 6 that she is so tied to her various tests that 7 at the end of the day, her recommended ROE as 8 we saw in 2009 is not really significantly 9 influenced by the state of the capital market 10 conditions. Ms. McShane tells us in her 11 report called "Trends in Economic and Capital 12 Market Conditions" that she is going to 13 address trends and cost of capital since the 14 oral portion of the 2010 GRA, but it is very 15 clear that there is nothing that directly ties 16 in with her estimates. Where, for example, do 17 we see any discussion of how the collapse in 18 the volatility or what she calls the fear 19 index has caused her to reduce her market risk 20 premium estimate? In fact, there is none, as 21 she increases her market risk premium 22 estimate, even as Canadian utilities access 23 funds at incredibly low rates for incredibly 24 long maturities.</p> <p>25 Now once again, we have Newfoundland</p>	<p>1 rate that is determined by ordinary investors, 2 rather it's an interest rate that has been 3 determined by the actions of the global policy 4 maker. Just prior to Operation Twist, Dr. 5 Booth testified that the Bank of Canada's June 6 2011 forecast for the long Canada bond yield 7 was back to the four and a half to five 8 percent range and he indicated that it would 9 not be appropriate for Newfoundland Power to 10 have a fair ROE determined by the actions of 11 the Fed.</p> <p>12 (11:30 a.m.)</p> <p>13 Dr. Booth estimated the impact of 14 Operation Twist by studying the yields on the 15 TSX preferred share index which he regards as 16 a distinctly Canadian investment because of 17 its tax treatment and noted that the yields on 18 the preferred share market did not come down 19 to the same degree as on government and 20 corporate bond yields following Operation 21 Twist.</p> <p>22 His credit spread adjustment, on the 23 other hand, takes into account recent research 24 at the Bank of Canada which looked at the 25 causes of the change in spreads between</p>
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<p>1 Power indicating that the Board should give 2 greater weight to recommendations arrived at 3 by the use of these multiple tests or multiple 4 methodologies and we'll come to these 5 methodologies shortly and how they've been 6 applied, but we submit that it has not been 7 established that the recommendation emanating 8 from these tests are deserving of greater 9 weight than Dr. Booth's recommendation. And 10 to the contrary, it has been established, in 11 our submission, that these other tests are not 12 substantiated and we will get to that. But 13 first to Dr. Booth's approach.</p> <p>14 Dr. Booth says that the fair ROE is in 15 the range of seven to eight percent with a 16 midpoint of 7.5 percent on 40 percent common 17 equity, which includes an 80 basis point 18 adjustment for Operation Twist and a 40 basis 19 point adjustment for credit spreads, for which 20 he sets out the rationale in his testimony.</p> <p>21 As Dr. Booth testified, the US Feds 22 Operation Twist was intended to literally 23 twist the yield curve and it worked. To the 24 point that Dr. Booth does not regard the long 25 term Canadian bond yield as representing a</p>	<p>1 corporate and government bond yields.</p> <p>2 Now next we turn to the market risk 3 premium. The Board is very familiar with the 4 market risk premium. The Board in its 2009 5 GRA decision stated that "the equity risk 6 premium test is for the most part based on 7 Canadian data and while it is necessary to 8 forecast for the future in assessing both the 9 market risk premium and the beta, this is the 10 sort of exercise that the Board is accustomed 11 to in the context of prospective regulation." 12 So this gets us into the whole question of 13 what is the expected market risk premium for 14 the market as a whole? We look at that before 15 we look at the relative risk of a utility as 16 compared to the market.</p> <p>17 Dr. Booth's analysis and judgment is that 18 the market risk premium is between five to six 19 percent and his estimate in that regard is 20 extremely well grounded. He considers 21 Canadian capital market history going back to 22 1924 which points to a market risk premium 23 under five percent, but he also gives weight 24 to US data. He observes that the Canadian 25 market risk premium has been about one percent</p>

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<p>1 lower than the United States, which has run 2 about six percent. Dr. Booth also considers 3 the results of an extensive survey by 4 Professor Fernandez of some 7200 survey 5 responses from financial analysts, companies 6 and professors of finance, and this survey, 7 which was published in June of 2012 shows that 8 2200 US respondents, they said that the 9 average market risk premium estimate was about 10 five and a half percent and for the 94 11 Canadian respondents, the average was about 12 5.4, right in line with Dr. Booth's estimate 13 of the market risk premium.</p> <p>14 By contrast, Ms. McShane has the market 15 risk premium up at eight percent. Dr. Booth's 16 estimate, we would submit is not only 17 consistent with survey results, it is 18 consistent with independent financial 19 institutions, such as TD Economics, whose 20 October 2012 report Dr. Booth refers to. Dr. 21 Booth is also consistent with Mr. MacDonald 22 who indicates that the market risk premium is 23 in the range of five to six percent and whose 24 report states that there was no evidence to 25 support a risk premium outside that range and</p>	<p>1 point out that regulators such as the National 2 Energy Board in its TQM decision in 2009 did 3 not accept the premise that these utility 4 betas revert to one as the Blume adjustment is 5 premised upon. Dr. Vander Weide is off the 6 charts altogether at .73 to .92 for his beta 7 estimate. As we say in our brief, Ms. 8 McShane's estimate is vastly in excess of any 9 beta range actually experienced by Canadian 10 utilities in the past 20 years. Dr. Booth's 11 evidence is that the Financial Post, Royal 12 Bank of Canada, Google, Yahoo Finance, they 13 don't adjust their beta estimates in the way 14 assumed by these other witnesses. The 15 Consumer Advocate recommends that the Board 16 put most weight on the actual experience of 17 Canadian utilities over the last 20 to 30 18 years because the fact is neither of the 19 witnesses put forward by Newfoundland Power 20 nor Mr. MacDonald have shown utility betas 21 following the Blume adjustment process.</p> <p>22 Now I'd like to say something about Dr. 23 Booth's use of discounted cash flow method. 24 He used to use that method regularly and he, 25 today, regards it as one of the two</p>
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<p>1 he too cites Professor Fernandez' survey. 2 The other thing quite telling from the 3 Fernandez study or survey is the direction of 4 the market risk premium for the United States. 5 The survey shows that estimates have it coming 6 down over 2009, 2010, 2011 into 2012, 7 descending from 6.4 percent in 2009 to five 8 and a half percent in 2012. So Ms. McShane is 9 not only high, Commissioners, she's going in 10 the wrong direction. In her May 2009 11 Newfoundland Power report, which she was 12 preparing in the immediate aftermath of the 13 meltdown in the market, she had the market 14 risk premium at 6.75 percent. Now she has it 15 at eight percent. Ms. McShane's judgment does 16 not pass the reasonableness test. Her 17 judgment is not constrained by the facts in 18 the capital markets.</p> <p>19 Then we turn to the relative risk of a 20 Canadian utility. Relative to the market as a 21 whole, Dr. Booth says it's somewhere between 22 45 to 55 percent because these are low beta 23 stocks. Mr. MacDonald is at .60, but Ms. 24 McShane is up around .65 to .70 on the basis 25 of the so-called Blume adjustment. I'd just</p>	<p>1 fundamental methods for determining the ROE. 2 However, he said applying it to Canadian 3 utilities is extremely problematic these days 4 as there are not many Canadian utilities 5 around and some of those who are around have 6 large levels of unregulated operations. 7 Neither Dr. Vander Weide nor Mr. MacDonald use 8 DCF estimates on Canadian utilities. Dr. 9 Booth has started to look at DCF estimates 10 from both the United States and from the 11 Standard and Poor's composite data for 12 electric and gas utilities. However, he says 13 given the substantive difference between the 14 United States and Canadian markets and 15 regulation, he regards these estimates as a 16 check only and as he indicated before the 17 BCUC, the estimates need to be reduced 90 to 18 100 basis points.</p> <p>19 What is important to note is that Dr. 20 Booth does use DCF methods to estimate the 21 fair return for the capital market as a whole, 22 which is an important element in anchoring his 23 risk premium estimates. Dr. Booth points out 24 in his Appendix D that he would judge the fair 25 rate of return on the Canadian market as a</p>

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<p>1 whole to be 9.3 percent and the fair return on 2 the US market to be between nine and a half to 3 ten and a half percent, so higher in the 4 United States than in Canada. He's also 5 anchored in this regard by reports such as the 6 TD Economics report.</p> <p>7 Newfoundland Power makes the point in 8 their brief that the use of long run geometric 9 estimations of returns is not advocated by any 10 expert in this proceeding. Well, first of 11 all, it's important to point out that Dr. 12 Booth referred to long run geometric returns, 13 but also said an adjustment was needed and he 14 said this repeatedly to make them arithmetic 15 rather than compound returns. Newfoundland 16 Power may not like it, but TD Economics puts 17 the long run compound return for equities at 18 seven percent, which when you convert to an 19 arithmetic basis, is around nine percent.</p> <p>20 Now I want to talk about the multiple 21 test or multiple methodologies. First let me 22 make this observation about Ms. McShane. Even 23 if you accept her risk adjusted equity market 24 premium test, which is derived from an 25 outsized eight percent market risk premium and</p>	<p>1 premium would have dropped -- result would 2 have dropped from 9.9 percent to 7.69 percent 3 and Mr. MacDonald's ERP would have dropped 4 from ten and a quarter to eight. Mr. 5 MacDonald, for his part, did not consider 6 doing it in the returns for returns way, 7 despite the fact that his report even had a 8 reference to it being a returns from returns 9 method. That line appeared in his report.</p> <p>10 Now we have to keep in mind that the 11 historic utility approach is supposed to be 12 estimating what the go-forward utility equity 13 risk premium is. As Ms. McShane's report 14 says, it is supposed to be an indicator of 15 what investors expect for the future based on 16 the premise that over the long term investors 17 expectations and their experience converge. 18 Using the approach of Ms. McShane, Dr. Vander 19 Weide and Mr. MacDonald, they are arriving at 20 risk premiums of around 6.7 to 6.7 (sic) 21 percent for a utility and using their 22 approach, you have to arrive at the conclusion 23 that utilities which have long been regarded 24 as being safer than the average company would 25 have warranted an addition 5.4 percent risk</p>
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<p>1 an outsized Blume adjustment beta, she still 2 gets to 8.9 percent, and secondly, we find it 3 rather interesting that she has actually 4 doubled her financing floatation allowance 5 from 50 basis points to a full one percent 6 allowance. Ms. Perry had no knowledge of 7 floatation costs doubling. We can only make 8 the assumption that it's getting increasingly 9 difficult for utility expert witnesses to 10 attempt to justify the ROE recommendations 11 that they are putting forward, which brings us 12 to the historic utility analysis. This is 13 what Dr. Vander Weide refers to as the ex 14 poste risk premium and Mr. MacDonald calls the 15 ERP.</p> <p>16 For many years, as this Board heard, Ms. 17 McShane admitted, indeed up to 2007, she would 18 deduct the returns earned on bonds from the 19 returns earned on stocks and that's how she 20 would arrive at the historic utility risk 21 premium. If she had used that approach, her 22 historic utility cost of equity would have 23 dropped from ten and a quarter percent to 24 around 7.97 percent, and by the same 25 procedure, Dr. Vander Weide's ex poste risk</p>	<p>1 premium over the entire TSX over the period 2 1956 to 2011.</p> <p>3 Now as came out during the hearing, this 4 historic utility approach was advocated by Ms. 5 McShane before the Alberta Utilities 6 Commission in the relatively recent 2011 7 generic cost of capital proceeding and the 8 Alberta Board agreed with the intervenors in 9 that case that part of the reason for higher 10 historical returns for the utilities over that 11 period may be that allowed returns have been 12 higher than the actual ROE that investors 13 expected and required for investments of 14 comparable risk. Therefore, the Alberta 15 Commission found that the evidence on historic 16 returns was inconclusive with respect to the 17 return investors expect on comparable 18 investments. Similarly, we submit that there 19 is no reasonable basis for the Board to 20 conclude that this method puts forward 21 reliable evidence with respect to the return 22 investors expect on a utility like 23 Newfoundland Power.</p> <p>24 Let me turn to a discussion of the 25 discounted cash flow test. Putting aside for</p>

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<p>1 the moment the question whether the company 2 has chosen to populate the samples of the 3 witnesses are similar to Newfoundland Power, 4 we have a more basic problem. It is clear 5 from the estimation methods used by Ms. 6 McShane, for instance, that the DCF estimate 7 falls from simply using analyst's long growth 8 estimates in the constant growth model to 9 tapering them down to the long run growth in 10 the economy at stage three and tapering them 11 down again when you use the actual forecast 12 ROE and financial parameters of the company 13 that generates the future growth, which is the 14 sustainable method.</p> <p>15 This is a clear indication that not only 16 are the short run analyst's growth estimates 17 unreasonable methods for long run growth, but 18 that using the long run GDP growth rate also 19 overestimates a reasonable long run growth 20 rate. So we ask a very simple question here. 21 What evidence has been put forward by 22 Newfoundland Power's witnesses or by Mr. 23 MacDonald to substantiate that the companies 24 they include in their samples of these very 25 mature utilities have historically been able</p>	<p>1 the recent 2011 Alberta generic cost of 2 capital proceeding were not able to achieve 3 anything close to compound US GDP growth over 4 the 20-year period from 1990 to 2010. Her US 5 firms, which include several companies 6 utilized by her in this proceeding, achieved 7 only 2.7 percent average growth in dividends 8 per share compared to the compound growth of 9 GDP of 4.7 percent over that long period. 10 (11:45 a.m.)</p> <p>11 And this is where Dr. Booth's concern 12 comes in as he expressed it at the hearing. 13 While conceptually DCF and risk premium models 14 are equally valid, it's very important that 15 any estimates of future growth for utilities 16 reflect reasonable constraints because of the 17 fact that these are slow growing mature 18 companies. As he testified, that's one 19 criticism that he has against some of the 20 other evidence before this Board, "that none 21 of the standard checks have been done." 22 That's a professor of finance at one of the 23 most well known universities in the country. 24 We submit that there is optimism built in to 25 these growth rates and we do not see evidence</p>
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<p>1 to achieve dividend growth rates anywhere near 2 what their forecast growth models are premised 3 on. The answer, of course as we know, is that 4 there is no evidence on the record to 5 substantiate that either the Canadian or the 6 US utilities were in fact able to achieve the 7 GDP growth rate historically.</p> <p>8 Now in Dr. Vander Weide's case, he 9 doesn't use a multi-stage DCF model at all 10 anyway, but the fact is that the multi-stage 11 model produces lower ROE estimates than the 12 constant growth model, precisely because 13 analyst's forecasts used in the constant 14 growth models, exceed forecast GDP growth. We 15 asked Dr. Vander Weide specifically in the RFI 16 process for data to substantiate whether his 17 firms were able to achieve growth rates as put 18 forward in the proceeding and he told us he 19 didn't examine historical dividend growth data 20 and he told me during the hearing to get the 21 data and analyze it. They're publicly 22 available.</p> <p>23 Now this Board will recall, however, that 24 we did find out from cross-examination of Ms. 25 McShane that her sample of US companies from</p>	<p>1 in this case that investors believe optimistic 2 forecasts. Similarly, the Alberta Board 3 didn't believe there was investor -- that 4 there was evidence that investors believe 5 optimistic forecast.</p> <p>6 As we stated in our brief, accordingly, 7 in our submission, inadequate substantiation 8 has been put forward by Newfoundland Power's 9 cost of capital witnesses and by Mr. MacDonald 10 to ground the Board's reliance upon DCF test 11 results in this proceeding. Basing the fair 12 return for Newfoundland Power on an analysis 13 so lacking in substantiation is not 14 reasonable.</p> <p>15 This brings us to the companies 16 themselves that were part of these witnesses' 17 samples. As we said in our opening statement 18 to the Board, Newfoundland Power has 19 essentially doubled down on the American 20 evidence in this case and it's just as 21 deficient as it was in 2009. As this Board 22 stated quite clearly in P.U. 43, in this type 23 of analysis, it's not enough that the chosen 24 comparables are the best available. If the 25 data is to be relied on it must be shown to be</p>



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<p>1 a reasonable proxy of that reasonable 2 adjustments can be made to account for the 3 differences. In this case, as in 2009, the 4 evidence is again overwhelming of a lack of 5 balance as it is clear that on almost every 6 measure, Newfoundland Power would have to be 7 considered less risky than the US comparables. 8 That essential fact has not changed, despite 9 the manner in which Ms. McShane has repackaged 10 the evidence. Dr. Vander Weide's samples are 11 even worse. The majority of Ms. McShane's 12 samples are from the 2009 case anyway. Of the 13 six companies she dropped for not meeting her 14 criteria, four of them are now in Dr. Vander 15 Weide's sample, amongst others that are 16 actually ranked by Standard and Poor's as 17 among the very weakest rated utility companies 18 in the whole of the United States.</p> <p>19 Despite what Ms. McShane and Dr. Vander 20 Weide say, Canada's business, as well as its 21 regulatory environment, has consistently been 22 seen as supportive relative to the United 23 States. Newfoundland Power is a relatively 24 low risk utility segment, being a transmission 25 and distribution company. The only firm in</p>	<p>1 samples, nor do several of the companies in 2 the samples have the full extension of weather 3 normalization protection that Newfoundland 4 Power has. Newfoundland Power operates in a 5 forward test year regime which is viewed as 6 being the least risky. Dr. Vander Weide's 7 July 2012 testimony in Missouri, which he 8 tabled in response to an undertaking, said 9 that the risk of regulatory lag can be 10 addressed by regulators through, amongst other 11 things, the establishment of forward looking 12 test years. Quite a number of companies in 13 these samples do not operate in forward test 14 year jurisdictions. Regulatory lag is an 15 issue in the United States, but it's not an 16 issue at all for Newfoundland Power, according 17 to Ms. Perry.</p> <p>18 Finally, Newfoundland Power has very 19 little earnings volatility. Ms. McShane 20 admitted that if you have lower year-to-year 21 return volatility, it may indicate that you've 22 got lower short term risk. Dr. Booth's 23 evidence clearly indicated that the 14 US 24 integrated electric utilities that he looked 25 at had significantly more earnings volatility</p>
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<p>1 the samples of either Ms. McShane or Mr. 2 MacDonald's sample that is truly a T&amp;D company 3 is Consolidated Edison. Newfoundland Power is 4 a completely regulated company, no unregulated 5 assets or earnings. As we detailed in our 6 brief, a number of the companies used in the 7 samples have significant levels of unregulated 8 revenue from segments that are not protected 9 from competition. Newfoundland Power's 10 customer base is very favourable. It has no 11 industrial customers and 87 percent of its 12 total customers are residential, a point made 13 explicitly by Newfoundland Power in its 14 presentation to both DBRS and Moody's in 15 February of 2011, which is found in 16 Undertaking 10. They note as well that 85 17 percent of their commercial electricity sales 18 are to customers in the service sector.</p> <p>19 It is very clear as well that 20 Newfoundland Power is relatively free of 21 competition. Moody's refers to them as 22 dominating the market which is geographically 23 isolated and effectively protected from 24 potential competition. Not so for the 25 companies in Ms. McShane's and Mr. MacDonald's</p>	<p>1 than Newfoundland Power. Newfoundland Power 2 was by far the lowest with a standard 3 deviation in its ROE of just .64 percent, 4 whereas for the United States utilities, it 5 ranged from 1.3 percent up to nearly eight 6 percent and certain of these companies with 7 higher volatility were in the samples of Ms. 8 McShane and Mr. MacDonald and most of the 14 9 companies examined are in Dr. Vander Weide's 10 comprehensive US utility group.</p> <p>11 So as was the case in 2009, Newfoundland 12 Power would have to be considered as less 13 risky than the US samples on nearly every 14 single measure and as Dr. Booth pointed out, 15 even if you would consider these companies to 16 be practically identical to Newfoundland 17 Power, you would still have to make 18 adjustments because of the United States 19 situation. This goes beyond the companies. 20 The issue for the Board to consider is whether 21 there is sufficient evidence to support a 22 finding that Canada's and the United States 23 regulatory institutional economic and 24 financial environments and their impact on the 25 resulting opportunities for investors or for</p>

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<p>1 rate regulated companies are comparable.</p> <p>2 We believe the evidence is very clear</p> <p>3 that you must make adjustments. As Dr. Booth</p> <p>4 notes, undeniably, long term bond yields are</p> <p>5 higher in the United States, at least 50 basis</p> <p>6 points higher than in Canada. He then says</p> <p>7 you look at the market risk premiums, historic</p> <p>8 evidence of the market risk premiums are of</p> <p>9 being higher in the United States, and you</p> <p>10 look at the Canadian utilities versus the US</p> <p>11 utilities. You can look at US evidence, but</p> <p>12 you have to make adjustments. Mr. MacDonald</p> <p>13 said the same thing.</p> <p>14 Ms. McShane and Dr. Vander Weide are the</p> <p>15 only ones who don't believe you have to make</p> <p>16 adjustments, and in the case of Dr. Vander</p> <p>17 Weide, he essentially believes that American</p> <p>18 regulators have been getting it right and</p> <p>19 Canadian regulators have been getting it wrong</p> <p>20 for decades. As Dr. Booth puts it, everybody</p> <p>21 in Canada has somehow been having these very</p> <p>22 in-depth four or five day hearings in the cost</p> <p>23 of capital and somehow in Canada we've been</p> <p>24 getting it wrong for the last 15-20 years?</p> <p>25 Dr. Booth doesn't think that's credible for it</p>	<p>1 rating, as they do not add fixed interest</p> <p>2 costs.</p> <p>3 As we point out in our brief, the</p> <p>4 reduction of the revenue requirement would</p> <p>5 have very, very modest impacts on interest</p> <p>6 coverage and cash flow to debt, a point we</p> <p>7 make at page 29. Newfoundland Power, in all</p> <p>8 due respect, is grasping at straws on this</p> <p>9 issue and they are setting up straw men</p> <p>10 arguments that they can knock down. We are</p> <p>11 not, and I want to make this perfectly clear,</p> <p>12 we're not suggesting that Fortis Inc. issue</p> <p>13 the preference shares and mirror them down to</p> <p>14 Newfoundland Power, nor is Dr. Booth</p> <p>15 suggesting, contrary to what Newfoundland</p> <p>16 Power's brief states, that they issue</p> <p>17 retractable preference shares either. They</p> <p>18 keep saying that issuing retractable</p> <p>19 preference shares as indicated by Dr. Booth</p> <p>20 would be effectively the same as issuing</p> <p>21 additional debt. But as we have pointed out</p> <p>22 at our brief on page 30, and as Newfoundland</p> <p>23 Power well knows, DBRS will typically treat</p> <p>24 preferred shares and hybrids as debt when the</p> <p>25 ratio of preferred equity and hybrids to</p>
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<p>1 means that every regulator in Canada has been</p> <p>2 deficient in evaluating the evidence before</p> <p>3 them. We would ask the Board to reject that</p> <p>4 notion.</p> <p>5 We are advocating, Dr. Booth is</p> <p>6 recommending, that the Board, for rate making</p> <p>7 purposes, reduce the common equity component</p> <p>8 in Newfoundland Power's capital structure to</p> <p>9 40 percent and replace for rate making</p> <p>10 purposes the five percent common equity with</p> <p>11 preferred shares. This does not require</p> <p>12 intrusion into the company's actual decisions</p> <p>13 regarding the utilities capitalization as this</p> <p>14 Board clearly stated in P.U. 19 in 2003.</p> <p>15 Newfoundland Power's capital structure</p> <p>16 with 45 percent common equity is higher than</p> <p>17 any other Fortis utility in the country and</p> <p>18 higher than Fortis Inc. itself. All the rest</p> <p>19 of the Fortis utilities are down around 40</p> <p>20 percent and the parent company is down to</p> <p>21 something slightly less than 35 percent common</p> <p>22 equity. Dr. Booth's report addresses the fact</p> <p>23 that preferred shares, unlike bonds, are</p> <p>24 similar to equity and are paid out of after</p> <p>25 tax income and therefore support the credit</p>	<p>1 common equity exceeds 20 percent, but with Dr.</p> <p>2 Booth's recommendation, the ratio will not be</p> <p>3 20 percent. It will only be 15 percent</p> <p>4 because we are adding five percent new</p> <p>5 preference shares on top of the one percent</p> <p>6 existing preference shares and the ratio of</p> <p>7 six percent to 40 percent common equity is</p> <p>8 only 15 percent, not 20. So that's a red</p> <p>9 herring.</p> <p>10 Furthermore, Dr. Booth testified that it</p> <p>11 was ridiculous, as he put it, that preferred</p> <p>12 shares could not be placed through a private</p> <p>13 placement. He said it's the investment</p> <p>14 banker's job to go out and sell these</p> <p>15 securities and you give them a commission and</p> <p>16 these securities will be placed somewhere. So</p> <p>17 the request that we've made in our brief is</p> <p>18 for the Board to direct Newfoundland Power to</p> <p>19 go out, get two quotes from investment dealers</p> <p>20 as to the cost of such an issue for approval</p> <p>21 by the Board or alternatively, and in the</p> <p>22 interim, recommend for rate making purposes</p> <p>23 that Newfoundland Power be deemed to have</p> <p>24 issued five percent preferred dividend shares</p> <p>25 at the same cost as the recent November 2012</p>

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<p>1 issue by Fortis.</p> <p>2 We regard this step as replacing five</p> <p>3 percent common equity with preference shares</p> <p>4 as a very moderated approach. As Dr. Booth</p> <p>5 put it, a halfway house between going to the</p> <p>6 same ratios as other Fortis utilities which</p> <p>7 have up to 60 percent debt in their capital</p> <p>8 structure. We are not requesting that the</p> <p>9 Board replace five percent equity with debt.</p> <p>10 It would result in savings to customers and it</p> <p>11 would not impair Newfoundland Power's</p> <p>12 financial integrity. We believe it is a very</p> <p>13 reasoned and balanced approach to take, as it</p> <p>14 would not be adding fixed interest and</p> <p>15 therefore would be supportive of the credit</p> <p>16 rating and it would bring Newfoundland Power</p> <p>17 closer to being at par with its sister</p> <p>18 utilities.</p> <p>19 Mr. MacDonald suggested that the capital</p> <p>20 structure is something that we should be</p> <p>21 constantly looking at and he expressed a</p> <p>22 concern about the sovereign debt crisis,</p> <p>23 particularly in the United States and he was</p> <p>24 looking at that in his determining that it was</p> <p>25 appropriate to maintain that at 45 percent</p>	<p>1 because of accounts like the OPEBs treatment</p> <p>2 and the OPEVA protections and it seems very</p> <p>3 clear, based upon definitions of financial</p> <p>4 risk that this Board has used in the past, as</p> <p>5 outlined in our brief, that Newfoundland Power</p> <p>6 has lower financial risk because of the 45</p> <p>7 percent equity component than most other</p> <p>8 utilities in the country.</p> <p>9 So, as Dr. Booth puts it in a passage</p> <p>10 that we have outlined in our brief at page 33,</p> <p>11 it's a logical conclusion that if Newfoundland</p> <p>12 Power is an average business risk utility and</p> <p>13 has lower financial risk, then it should have</p> <p>14 a lower allowed ROE than a benchmark Canadian</p> <p>15 utility or its common equity should be</p> <p>16 reduced. Dr. Booth indicated that he</p> <p>17 refrained from making a capital structure</p> <p>18 recommendation previously due to the state of</p> <p>19 capital markets. However, as he pointed out,</p> <p>20 as time passes and the markets heal, the need</p> <p>21 for such a high equity ratio passes.</p> <p>22 Newfoundland Power, in their brief, attempts</p> <p>23 to make hay from the fact that Dr. Booth</p> <p>24 didn't recommend a change in the capital</p> <p>25 structure in May of 2012. I would just point</p>
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<p>1 until we had clarity or some clarity on those</p> <p>2 issues. We would submit that Dr. Booth's</p> <p>3 evidence is to be preferred on this point.</p> <p>4 The macro economic conditions are not such as</p> <p>5 to continue to justify Newfoundland Power</p> <p>6 having 45 percent common equity when its</p> <p>7 sister utilities have 40 percent and they are</p> <p>8 subject to the same macro economic issues as</p> <p>9 Newfoundland Power. And keep in mind as well</p> <p>10 that Dr. Booth's proposal still gives</p> <p>11 Newfoundland Power pretty much the best</p> <p>12 capital structure across Canada, in terms of</p> <p>13 utilities.</p> <p>14 Further, as we set out in our brief from</p> <p>15 the standpoint of business risk and financial</p> <p>16 risk, we submit that at the very most,</p> <p>17 Newfoundland Power has average business risk</p> <p>18 compared to other utilities. It certainly</p> <p>19 does not have above average risk compared to</p> <p>20 other utilities, that's for sure, in our</p> <p>21 submission. Although that was a point that</p> <p>22 Ms. Perry did not want to concede.</p> <p>23 Over the past few years, Newfoundland</p> <p>24 Power's business risk, certainly in terms of</p> <p>25 its earnings volatility, has only improved</p>	<p>1 out that it's very well known that 2012 was an</p> <p>2 interim arrangement for 2012 and there would</p> <p>3 be a full contested GRA, which is precisely</p> <p>4 the process that we're sitting in now.</p> <p>5 Newfoundland Power, once again, wants to</p> <p>6 make light of the extensive cross-examination</p> <p>7 on risk differences between Canadian</p> <p>8 utilities, including differences between BC</p> <p>9 utilities and Newfoundland Power. And you'll</p> <p>10 recall that Newfoundland Power was similarly</p> <p>11 dismissive about cross-examination in its last</p> <p>12 GRA about the US utilities that Ms. McShane</p> <p>13 was referring to. But the key thing with this</p> <p>14 BC evidence is that this is Ms. McShane's own</p> <p>15 evidence that she spoke to only a month before</p> <p>16 she testified here and it's quite useful for</p> <p>17 putting the discussion around the risk that</p> <p>18 Newfoundland Power faces into a perspective</p> <p>19 for the Board. Ms. McShane's evidence in</p> <p>20 British Columbia was that generically, the</p> <p>21 lowest risk is electricity transmission, and</p> <p>22 of course, Newfoundland Power does have some</p> <p>23 transmission. Next would be electricity</p> <p>24 distribution, that would apply to Newfoundland</p> <p>25 Power. Higher in terms of risk would be</p>

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<p>1 natural gas distribution and the highest would 2 be vertically integrated utilities. 3 (12:00) 4 Now in FEI in British Columbia, that's a 5 natural gas distribution company. It's larger 6 than Newfoundland Power. It's a heating load 7 gas utility which has more exposure to 8 declining throughput due to factors such as 9 smaller and more energy efficient houses than 10 electricity distributors. Unlike Newfoundland 11 Power, which has a capture rate of around 90 12 percent in new residential units, FEI's 13 capture rate in new multi-unit dwellings 14 continues to be materially lower than in 15 single family housing, only 30 percent in 16 multi-unit where the trend is going in that 17 market versus 70 percent in the single family 18 housing units. Ms. McShane's evidence was 19 that usage rates of new residential customers 20 of FEI was 50 percent lower than that of 21 existing customers. Natural gases share of 22 the BC market is just under 50 percent, well 23 lower than the share that natural gas enjoys 24 in Ontario and in Alberta. Alberta, I 25 believe, is up to 80 percent according to her</p>	<p>1 argument that Newfoundland Power's size erases 2 all of the advantages that Newfoundland Power 3 enjoys by way of these other business risk 4 indicia, whether it is belonging in a low risk 5 T &amp; D sector, to its being market dominant, to 6 its having little competition. There is no 7 objective evidence that Newfoundland Power is 8 required to have 45 percent common equity to 9 be an average risk Canadian utility. We were 10 very struck in this hearing when our learned 11 friend, Ms. Greene, Q.C. asked Ms. McShane to 12 name a Canadian utility with a lower risk than 13 Newfoundland Power. You will recall that 14 there was an extended silence. The only one 15 that she could come up with as Altalink, which 16 she said would have a lower business risk, and 17 that's been reflected in a lower common equity 18 ratio by the Alberta Utilities Commission, but 19 even then she qualified it by saying, I'm not 20 sure when you look at it on an overall basis 21 it's necessarily that much lower risk. It's 22 pretty telling when the company's main capital 23 witness couldn't think of a utility in Canada 24 with lower risk than Newfoundland Power. Now 25 finally, I would like to address something</p>
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<p>1 evidence. Her evidence clearly displays that 2 FEI is facing competitive pressures. They're 3 facing provincial energy policies which are 4 discouraging of the use of fossil fuels, and 5 promoting the development and use of clean 6 energy technologies and renewable resources. 7 FEI is subject to a carbon tax on its natural 8 gas. According to Ms. McShane in her own 9 evidence, FEI's operating risk includes 10 outages, gas leaks, severe weather, natural 11 disasters, it operates in a remote and rugged 12 terrain subject to damage from a variety of 13 natural events, including avalanches, 14 landslides, fires. So Newfoundland Power is 15 not alone when it comes to challenging 16 operating environments, and all the while Ms. 17 McShane says that FEI's regulatory risk is 18 increasing and it's increasingly involving 19 regulatory lag and uncertainty that stems from 20 the changing energy environment. Ms. 21 McShane, however, would only concede that FEI 22 is of "somewhat higher fundamental business 23 risk than Newfoundland Power". She says she 24 would consider them relatively similar if you 25 consider the size issue. We do not accept the</p>	<p>1 that I never addressed in my brief, but it was 2 a contention of Ms. McShane that her 3 recommendation for the fair ROE would increase 4 by about 50 basis points if the common equity 5 component was lowered by 5 percent. We would 6 urge great caution here. In our respectful 7 submission, the Board would only adjust the 8 ROE if the Board found that Newfoundland Power 9 is an average risk utility and their capital 10 structure is more aggressive than the average. 11 That is to say that if the average common 12 equity for a firm like Newfoundland Power was 13 40 percent, and the Board gave Newfoundland 14 Power 35 percent like Fortis uses, then you 15 would adjust the ROE. However, in this case, 16 we are simply moving an average risk utility 17 to the average common equity ratio and 18 recommending an average ROE. I would urge 19 caution as well in Mr. Kelly's reference to 20 Schedule 3 to Ms. McShane's Report of allowed 21 ROEs. Those allowed ROEs include ROEs from 22 companies that are like PNG and Nova Scotia 23 Power, which Ms. McShane puts at being the 24 highest risk in the country. We end this 25 capital structure discussion by stating to you</p>

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<p>1 that there's no objective evidence that  2 Newfoundland Power requires 45 percent common  3 equity to be an average risk Canadian utility.  4 Dr. Booth's preference share proposal  5 represents a balanced and reasonable approach  6 to lowering Newfoundland Power's common equity  7 ratio for rate making purposes. As regards  8 the weight of expert cost of capital evidence,  9 we submit that the evidence of Dr. Booth is  10 entitled to the greatest weight before the  11 Board. His evidence is clearly more tied to  12 the circumstances of the capital markets.  13 Neither Dr. Vander Weide or Mr. MacDonald  14 discussed in any substantive fashion the  15 capital markets. With Ms. McShane, there is  16 nothing that directly ties in with her  17 estimates. To a great extent, her estimates  18 are detached from the general capital market  19 discussion. Were she to more accurately  20 incorporate her discussion of capital market  21 conditions into her testimony, it would lead  22 inevitably to a lowering of her fair ROE  23 recommendation. Dr. Booth, in contrast, is  24 the only witness that has substantively looked  25 at the development of capital market</p>	<p>1 forward risk premium for Canadian utility.  2 Recall as well that the DCF tests are not  3 backed up by substantiation. Consider whose  4 recommendations for the fair ROE is actually  5 tethered to the real world. Consider the  6 indications from TD Economics, Royal Bank of  7 Canada. These institutions are independent.  8 We would urge you to reflect on whether it  9 truly constitutes good judgment to come before  10 the Board, as the utility witnesses have done,  11 and tell you that what is at worst an average  12 risk Canadian utility like Newfoundland Power  13 should be awarded 10.5 percent on its common  14 equity. Consider what that would mean in the  15 context of people who are saving for their own  16 retirements, or the returns that are being  17 achieved in pension plans. Does that  18 constitute judgment constrained by facts?  19 Seemingly, these witnesses wish for us to  20 forget the outside world when we enter this  21 room, and park commonsense out by the door.  22 And least it should be considered that Dr.  23 Booth, who would put the return between 7 and  24 8 percent at 7.5 is a low ball estimator,  25 consider Dr. Booth's evidence that every</p>
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<p>1 conditions since 2008, both in terms of the  2 credit risk adjustment he used, and his  3 recognition of the impact of the US operation  4 "Twist". In assessing the weight to be given  5 to the witnesses, we would urge that the Board  6 look at the actual details by which they  7 arrive at their recommendations, not just the  8 recommendations alone. The DCF based equity  9 risk premium test carried out by Ms. McShane  10 and Dr. Vander Weide, as we outlined in our  11 brief at page 26, showed dramatic decreases in  12 the DCF cost of equity from 2009 to 2012. In  13 Ms. McShane's case, 180 basis point drop. Dr.  14 Vander Weide's case, 190 basis point drop  15 since this Board heard the evidence in the  16 last Newfoundland Power GRA, and 320 basis  17 points down from March, 2009, relative to  18 where they stood in June, 2012. We ask the  19 Board not to permit new and inventive ways of  20 carrying out the historic utility premium test  21 or inventiveness in relation to the financing  22 flow station costs to distract you from this  23 fact. Keep in mind as well that the historic  24 utility method, however these witnesses have  25 labelled it, is not representative of the go</p>	<p>1 utility in Canada has got a market to book  2 ratio of about 1.4 to 1.8 percent, as he  3 stated. It means, as he put it, that  4 investors are very, very happy with allowed  5 ROEs in Canada. We submit that Dr. Booth's  6 evidence is clearly the most deserving of the  7 weight to be given by the Board. In relation  8 to the automatic adjustment formula, both the  9 Board's staff witness, Mr. MacDonald, and Dr.  10 Booth, recommended a formula. The consumer  11 advocate supports the recommendation of Dr.  12 Booth's automatic adjustment formula. Dr.  13 Booth's addition of a 50 percent adjustment  14 for credit spreads has been accepted by the  15 Regie and the OEB. In this, he and Mr.  16 MacDonald are in agreement, as was Ms. McShane  17 previously before the NEB, and the Regie. So  18 there is consensus on that point. This Board  19 has a long history of using the formula and we  20 regard Dr. Booth's recommendation as regards  21 adjustment to changes in long Canada bond  22 yields as reasonable, and in line with the  23 Board's historical adjustment mechanism. Dr.  24 Booth's evidence was that a 50 percent change  25 is recommended by Mr. MacDonald and by Ms.</p>

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<p>1 McShane in the Regie case violated basic 2 economic assumptions and was rejected by the 3 Regie, who adopted Dr. Booth's 75 percent 4 change. Dr. Booth testified that the 5 adjustment factor would provide consistency 6 with prior decisions of the Board as interest 7 rates revert to normal. The consumer advocate 8 recommends Dr. Booth's approach to deal with 9 the current situation of exceptionally low 10 interest rates. Dr. Booth recommends a floor 11 for the long Canada bond yield forecast to be 12 set at 3.8 percent. This ensures that unless 13 the long Canada bond yield substantially 14 increases and moves back to normal range, 15 there is no change in the allowed ROE. As 16 regards operating cost, the impact of new 17 provincial regulations regarding generic 18 drugs, we deal with this, of course, in our 19 brief at page 38 and 39. We submit that the 20 revenue requirement of Newfoundland Power 21 should reflect some cost savings arising from 22 the passage of this legislation. Section 5 of 23 the legislation mandates that the price for a 24 product listed in the formulary shall not 25 exceed 40 percent of the brand price, and this</p>	<p>1 of the legislation would be zero. We have 2 attempted and it's only an attempt, to make a 3 better forecast than assuming, as the company 4 did, that there would be absolutely no impact. 5 We base that off the admitted fact that about 6 60 percent of the plan is geared toward 7 generic drugs, and the evidence from Ms. Perry 8 indicated that Blue Cross provided that the 9 impact on at least certain drugs could be as 10 high as 20 percent. So we put forward as a 11 more reasonable assumption, an assumption of a 12 6 percent reduction in OPEB's expense rather 13 than a zero percent impact, and the 6 percent 14 figure is arrived at by assuming « of the as 15 high as 20 percent impact, so 10 percent, and 16 assuming - and applying that savings to 60 17 percent of the total expense, which is the 18 portion that relates that generic drugs. It's 19 imperfect, perhaps imprecise, but better than 20 assuming no cost reduction, and obviously, as 21 we point out, these regulations were designed 22 to benefit everyone who must pay for the 23 generic drugs, and, therefore, the only way to 24 pass the benefit on through the rate payers in 25 a timely manner is to adjust the OPEB's</p>
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<p>1 applies for the period from October 1st, 2012, 2 to March 31st, 2013, but from April 1st, 2013 3 onward, the product shall not exceed 35 4 percent of the brand price. The bottom line 5 is that the savings or potential savings from 6 the regulation are not reflected in the 2013 7 and 2014 test year, OPEB's expense. The 8 company's actuary simply uses historical data 9 to extrapolate forward for the purposes of 10 accounting. So obviously an extrapolation of 11 historical data could not reflect the downward 12 impact of the legislated reduction in generic 13 drug costs, and while the Mercer approach is 14 standard for financial reporting purposes, 15 it's not meant to be a forecast that would 16 meet accepted standards for determining 17 forecast for a test year that should be 18 recovered in the customer's rates. So our 19 proposition is that the forecast of costs that 20 are included in the rates should reflect all 21 known cost drivers that will result in higher, 22 or in this case, what we believe to be lower 23 rates than are derived by simply extrapolating 24 past costs. We believe that that will be a 25 fairer way to go than assuming that the impact</p>	<p>1 expense as included in rates for 2013 and 2 2014, and to the extent that it's a mis- 3 estimate, the OPEBDA will ensure the actual 4 cost will be ultimately passed on to 5 customers. I turn now to the retirement 6 allowances. Customers of Newfoundland Power 7 have a right to expect that the management and 8 operation of the company is carried out at the 9 lowest possible cost consistent with the 10 provision of safe, reliable service. 11 Newfoundland Power, as a matter of course, 12 offers costly retirement allowance benefits to 13 new hires. In the case of a new unionized 14 employee, that's a matter of a collective 15 agreement that's presently in force. So that 16 remains an extant obligation. However, there 17 is no extant obligation to continue to offer 18 retirement allowances to new hires who join 19 the non-unionized ranks of Newfoundland Power. 20 There's absolutely no doubt that Newfoundland 21 Power is a well regarded, well sought after 22 employer, as was clear through the cross- 23 examination of Mr. Smith. Newfoundland Power 24 receives multitudes of qualified applications 25 from prospective employees whenever it issues</p>

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<p>1 a public advertisement for a position at the 2 company, but the fact is with the coming 3 demographic changes in the workforce at 4 Newfoundland Power, customers should not have 5 to bear the cost of retirement allowances for 6 these new hires. This retirement allowance 7 entitles the new employee hired today to 8 receive approximately a half a year's salary 9 when he or she retires in the future in the 10 normal course. That is an avoidable and 11 unnecessary expense, and I don't think that my 12 learned friend would dispute the fact that 13 there has been movement in that regard by the 14 Federal Government, the RCMP, and those 15 institutions. So what we say is that this is 16 a avoidable and unnecessary expense, and this 17 is the time to bring reform to the issue. As 18 the evidence discloses, by 2017, employees 19 with less than 10 years of service will be 20 making up approximately 45 percent of the 21 workforce, and as we point out and provide 22 specific examples of, there's a growing trend 23 away from the payment of retirement 24 allowances. As you will note from the 25 materials filed, we talk about New Brunswick,</p>	<p>1 OPEBs expense. This is precisely what we want 2 to see in relation to these retirement 3 allowances. At this time, the consumer 4 advocate submits that the revenue requirement 5 for 2013 and 2014 should not include any 6 recognition of future retirement benefit costs 7 in the form of retirement allowances for non- 8 unionized employees who commence employment 9 with Newfoundland Power during the test years 10 2013 and 2014 or beyond. As regards executive 11 compensation and the short term incentive 12 aspect of it, in a nutshell, what we're 13 submitting is that the revenue requirement for 14 2013 and 2014 should not include the portion 15 of the short term incentive pay for executives 16 or managers resulting from the achievement of 17 targets relating to earnings. Achievement of 18 the 34 million or 35 million or 40 million 19 dollars in earnings which will get paid out to 20 dividends to the shareholders of Newfoundland 21 Power is clearly for the primary benefit of 22 shareholders, and not for the primary benefit 23 of rate payers, and we address this issue in 24 detail in our brief. In our submission, short 25 term incentive targets for things like</p>
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<p>1 we talk about the Federal Government. 2 (12:15 P.M.) 3 Now you may recall in the last GRA that there 4 was to'ing and fro'ing that we had to do with 5 Newfoundland Power over the fact that they 6 were providing free health care benefits to 7 retirees, something that Hydro and other 8 institutions were not doing. Newfoundland 9 Power did not want to introduce reforms, but 10 eventually they did and the reforms were 11 rather modest because they made no changes to 12 the plan for any existing retirees, and they 13 made no changes for employees who retire or 14 who are eligible to retire before December 15 31st, 2012, but what they did do is bring in a 16 50 percent member pay cost sharing arrangement 17 for retirees over the age of 65, not including 18 those groups I just mentioned who were 19 exempted. The company reports, and it's on 20 the record in CANP-504, that the cost savings 21 of these amendments to Newfoundland Power's 22 OPEBs plan are reflected in the decrease in 23 the accrued OPEB's obligation of 15.2 million 24 dollars, and they state that the decrease in 25 the OPEBs obligation serves to decrease future</p>	<p>1 reliability, customer satisfaction, injury 2 frequency rates, controllable operating costs 3 for customers, these fall into a separate 4 category, as these are performance measures 5 which, if achieved, provide direct benefits to 6 the rate payers. We submit that the same does 7 not hold true for an earnings target. We have 8 provided in our brief references to the 9 approach on this matter by other Canadian 10 regulatory boards. The Northwest Territory 11 Board, for instance, held in a 2007 decision 12 that the portion of the utilities at risk 13 compensation program that was based on net 14 income targets should be borne by 15 shareholders, not rate payers. We reference 16 as well the Ontario Distribution Rate Book 17 from 2006, which indicated and stated that 18 incentive payments related to benefits to 19 shareholders would not be recoverable in the 20 2006 revenue requirement, and we provided as 21 well a decision concerning the EUB and it was 22 then known in Alberta, which denied ATCO 23 Electric's inclusion of a portion of its 24 variable pay plan which was focused on 25 financial returns. The Board held in the</p>

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<p>1 Alberta case that it was not appropriate to  2 fund the portion of the variable pay plan that  3 had been set up for 15 senior employees  4 through rates where the benefit of the  5 variable pay plan primarily provided an  6 increased return to the utility. We do not  7 regard the present case involving Newfoundland  8 Power's compensation targets being tied to  9 earnings, as truly being distinguishable from  10 the regulatory precedents that we put before  11 you. Accordingly, we would urge the Board to  12 not permit this portion of the STI for  13 Newfoundland Power's executives or managers to  14 be included in revenue requirement for the  15 test years. In relation to the conservation  16 plan, we discussed the conservation plan at  17 pages 48 to 51 in our brief. We recognize  18 that the new five year plan jointly prepared  19 by Newfoundland Power and Hydro is a very  20 recent document tabled only in this GRA  21 proceedings. Pursuant to those initiatives  22 described in the plan, Newfoundland Power is  23 forecasting increasing spending in the area  24 over 2013 and 2014 over spending levels  25 previously. Our overall recommendation at</p>	<p>1 resulted in the highest amount of energy  2 savings of all the programs, is not being  3 further intensified, now particularly that the  4 new housing stock is being taken care of  5 without the need for incentives because of the  6 building code requirements, and frankly, I  7 view this as problematic when we have 96  8 percent when we might as well say 100 percent  9 of electricity customers indicating that their  10 primary motivation for trying to cut back on  11 electricity use is to save money, and the  12 significantly increased level of spending on  13 the small technologies portfolio, such as the  14 CFLs, the LED lighting, and the Energy Star  15 appliances will not do as much to benefit a  16 heating customer in terms of a bill impact  17 such as the insulation of a basement or an  18 attic would. So frankly, I'm submitting that  19 it will be necessary to examine how well the  20 program portfolio is aligning with the view of  21 those electricity customers who want to save  22 money by lowering their bills. So I question  23 the insulation for that matter, the windows  24 piece for the existing housing stock, and I  25 think the review should look at the benefits</p>
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<p>1 this stage is, I believe, a fairly practical  2 one in the sense that we cannot really have a  3 complete discussion about the merits and  4 shortfalls and criticisms, and areas of  5 improvement that may arise from this plan in  6 the absence of Newfoundland and Labrador  7 Hydro, where this is, after all, a joint plan.  8 At this stage, I'm not prepared to be  9 condemnatory, nor completely congratulatory  10 because I think, frankly, it would be  11 premature because I believe that the plan  12 needs to be considered in a proper framework  13 which allows for proper examination. I will  14 state, however, that greater emphasis is being  15 placed on energy conservation, and I  16 acknowledge that the utilities report growing  17 participation in the programs, and certainly,  18 as I think we all know, the publicity around  19 the Take Charge Program has been pretty  20 widespread. On the downside, I am concerned  21 that the programs which have been shown to be  22 providing a very good bang for the buck in  23 terms of the energy savings and the impact on  24 customer's individual bills, such as the  25 insulation program which, in fact, has</p>	<p>1 and costs that would arise from more  2 aggressive targeting of that segment. In that  3 regard, I would submit that not only  4 Newfoundland Power, but Newfoundland Hydro,  5 should have actual targets in place in terms  6 of the number of customers they're trying to  7 reach with the respective offerings. At the  8 present time there are no targets established  9 at Newfoundland Power to reach any particular  10 number of customers in relation to the  11 programs that they offer. We submit that this  12 should be part of the review of the recent  13 five year plan. I would subscribe to the  14 adage that "if you measure it, you will manage  15 it". I refer as well to Mr. Adams testimony  16 before the Board, in which he provided a  17 detailed presentation and brought forward a  18 series of recommendations. His conclusions  19 included that the program is inappropriately  20 funded and that the measures had no meaningful  21 impact for electricity customers. He  22 concluded that the plan does little to reduce  23 system feed loads, amongst other concerns.  24 His evidence with respect to the potential  25 energy in peak savings that could arise from</p>



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<p>1 air sealing homes and through the use of  2 ductless heat pumps was quite detailed. The  3 technology which he described has been  4 available, according to Mr. Adams, for about  5 eight years in this province, and according to  6 Mr. Adams has shown quite a level of success  7 in studies in certain jurisdictions in the  8 United States, and he also, of course,  9 described a pilot study which he was involved  10 in in this jurisdiction, and though it was  11 informal, it was still persuasive. It says to  12 me that the potential for this technology to  13 be incented on a cost effective basis should  14 definitely be formally and professionally  15 assessed. Therefore, what we are recommending  16 to the Board is that the Board initiate a  17 process, in consultation with both utilities  18 and the consumer advocate, that would allow an  19 appropriate review of the plan involving  20 interested parties and to allow an opportunity  21 for input. Turning to depreciation, in our  22 brief we outlined that the precision of  23 estimates required with the ELG, and we point  24 out the inability to predict the future in  25 terms of retirements and it produces a greater</p>	<p>1 a precise or even close to precise pattern  2 that would retain the appropriate relationship  3 developed for ELG annual vintage rates on an  4 annual basis. So we submit that Mr. Wiedmayer  5 has not effectively refuted that criticism  6 that Mr. Pous has put forward as regards to  7 time sensitivity issue. No one disputes that  8 the reason we pay less in depreciation expense  9 today is because depreciation expense for  10 Newfoundland Power has historically been  11 higher since 1978 under ELG depreciation than  12 it would be had ALG rates been used.  13 Precisely because customers paid more in the  14 past, we pay less today. Newfoundland Power  15 says 3.7 million dollars less in 2014, but, of  16 course, that's based on a 10.4 percent return  17 on common equity for 2014, but logically if  18 you pay faster or you pay higher amounts in  19 earlier years, you're going to pay lower  20 amounts in later years. Mr. Wiedmayer himself  21 acknowledged that under the ELG procedure,  22 depreciation accruals may be higher in earlier  23 periods and lower in later periods. Mr. Pous,  24 for his part, states it's not a "may"  25 proposition, it's a "will be" higher in</p>
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<p>1 degree of error for ELG over ALG. Mr. Pous  2 states that, "When the variance between future  3 estimates and actual future events happens,  4 and corrective action is taken, the ELG  5 magnifies the degree of error that has to be  6 corrected". Mr. Pous stated that this is  7 significant, given that the utility industry  8 has historically lengthened the expected  9 average service life of investments in the  10 accounts. We submit that this position has  11 not truly been refuted on the record at this  12 proceeding. As regards time sensitivity, Mr.  13 Pous testified quite clearly as to the real  14 life reasons why the ELG calculation procedure  15 is more time sensitive than the ALG procedure,  16 and in that regard, we would refer you in your  17 deliberations to page 55 of our brief. We  18 submit respectfully that this position  19 likewise has not been truly refuted by  20 Newfoundland Power or Mr. Wiedmayer. Mr.  21 Wiedmayer attempts to address the time  22 sensitivity problem by saying that utility  23 property is constantly being added and  24 retired, but the plant additions and  25 retirements, as Mr. Pous says, do not occur in</p>	<p>1 earlier period situation. Mr. Wiedmayer  2 referred to Mr. Pous' proposal to use ALG  3 depreciation rates as only resulting in a  4 narrow short term benefit, and he stated, "The  5 temptation to reduce depreciation expense in  6 the short term must be weighed against the  7 full impact of the proposal". He stated,  8 "From the perspective of inter-generational  9 equity, it's not a proper practice to provide  10 a short term benefit to current customers at  11 the expense of all others". You will recall  12 the discussion with Mr. Wiedmayer about the  13 short term nature of what he termed the  14 "benefit". We're not talking about a short  15 term situation here. I think that's important  16 to consider. We are talking about taking more  17 than 11 to 15 years to reach the point where  18 customers would be paying the amount that Mr.  19 Pous has stated that they should have been  20 paying all along. Mr. Wiedmayer says that  21 this 11 to 15 year period was longer than what  22 he had originally thought. He said in his  23 evidence, "Sometimes when I've done that  24 calculation, the crossover occurs somewhere in  25 the seven year time frame", and that 11 to 15</p>

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<p>1 year time frame only gets longer if</p> <p>2 Newfoundland Power is awarded less than 40.</p> <p>3 percent on its ROE, but already at 11 to 15</p> <p>4 years we're talking out to 2024 to 2028. We</p> <p>5 advocate ALG not because we have succumbed to</p> <p>6 a temptation. We advocate ALG as the method</p> <p>7 by which the vast majority of customers in</p> <p>8 North America have their depreciation expenses</p> <p>9 determined, and a method that does not result</p> <p>10 in a situation where depreciation accruals are</p> <p>11 higher in earlier periods and lower in later</p> <p>12 periods, and a method, in our respectful</p> <p>13 submission, that is more aligned with the</p> <p>14 reality of how depreciation actually gets</p> <p>15 implemented in the utility industry, and in</p> <p>16 rate cases.</p> <p>17 (12:30 P.M.)</p> <p>18 Now I fully appreciate the technical nature of</p> <p>19 the depreciation debate, and as anybody who</p> <p>20 was here, and perhaps it can be said had to</p> <p>21 endure some of the discussion about the</p> <p>22 accounts, it's slow going stuff, and I'm not</p> <p>23 going to proceed to go through each of these</p> <p>24 accounts with you. I think you've suffered</p> <p>25 enough. I just want to leave with you a</p>	<p>1 enjoyed it once again before this Board, and I</p> <p>2 thank you very much for your attention to the</p> <p>3 submissions that I've made.</p> <p>4 CHAIRMAN:</p> <p>5 Q. Do you have any -</p> <p>6 KELLY, Q.C.:</p> <p>7 Q. No, Mr. Chairman, that would be repetitive.</p> <p>8 I'd simply echo Mr. Johnson's comments at</p> <p>9 closing. We thank -</p> <p>10 COMMISSIONER NEWMAN:</p> <p>11 Q. Excuse me, I do actually have a question.</p> <p>12 CHAIRMAN:</p> <p>13 Q. Oh, I'm sorry, I beg your pardon.</p> <p>14 COMMISSIONER NEWMAN:</p> <p>15 Q. Mr. Johnson, I wanted to ask you to provide</p> <p>16 your position on Dr. Booth's suggestion that</p> <p>17 the Board could establish an ROE for</p> <p>18 Newfoundland Power of 8.25 percent for an</p> <p>19 indefinite period, more in relation to the</p> <p>20 indefinite period and a certain ROE than it is</p> <p>21 to the particular number of 8.25?</p> <p>22 MR. JOHNSON:</p> <p>23 Q. Right. I think that position is borne more</p> <p>24 out of a finance point of view than it would</p> <p>25 be borne out of a jurisdictional consideration</p>
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<p>1 couple of key observations as regards the</p> <p>2 Board's determinations on these accounts. We</p> <p>3 submit, first of all, that the Board shouldn't</p> <p>4 give Newfoundland Power's depreciation expert</p> <p>5 an automatic pass on the accounts because of</p> <p>6 his relationship with Newfoundland Power and</p> <p>7 the fact that he's met with the company</p> <p>8 personnel. We would urge you to look at the</p> <p>9 evidence on each of the accounts and to see if</p> <p>10 it stands up to scrutiny. Where you find Mr.</p> <p>11 Pous is all wet, I'm sure you'll say where</p> <p>12 he's all wet, but where Mr. Pous is saying,</p> <p>13 look, this is an account that was largely</p> <p>14 based upon an analysis of the actuarial data,</p> <p>15 we would suggest that you weigh the arguments</p> <p>16 back and forth on the analysis in an even</p> <p>17 manner. That's all I can really ask of you,</p> <p>18 and I'm not going to further go into the</p> <p>19 particulars, and I have set out those general</p> <p>20 observations in my Brief. I guess to conclude</p> <p>21 my comments, I'd like to acknowledge the Board</p> <p>22 and the Board staff throughout the proceeding,</p> <p>23 acknowledge my friends at Newfoundland Power.</p> <p>24 These cases are tough. I can say I'm happy to</p> <p>25 see the back of it, but I've nevertheless</p>	<p>1 that the Board may wish to weigh, and -</p> <p>2 because there would be nothing to preclude, I</p> <p>3 think, a Board - or a utility from making an</p> <p>4 application to come before the Board to have a</p> <p>5 cost of equity determined, and for the Board</p> <p>6 to act on the evidence that was brought before</p> <p>7 it. So I see where Dr. Booth was driving at,</p> <p>8 but I don't think that that is a proposal that</p> <p>9 in the context of the Public Utilities Act</p> <p>10 that you could solidify a return for five</p> <p>11 years and then lock it up without review.</p> <p>12 COMMISSIONER NEWMAN:</p> <p>13 Q. Okay.</p> <p>14 (12:33 P.M.)</p> <p>15 CHAIRMAN:</p> <p>16 Q. I guess if there's nothing further then, we</p> <p>17 are finito. Thank you all very much and we</p> <p>18 will have a decision.</p> <p>19 (HEARING CONCLUDED)</p>

## 1 CERTIFICATE

2 I, Judy Moss, do hereby that the foregoing is  
3 a true and correct transcript of a hearing in the  
4 matter of Newfoundland Power Inc.'s General Rate  
5 Application heard on the 8th day of February, 2013  
6 at the offices of the Board of Commissioners of  
7 Public Utilities, St. John's, Newfoundland and  
8 Labrador and was transcribed by me to the best of  
9 my ability by means of a sound apparatus.

10 Dated at St. John's, NL this

11 12th day of February, 2013

12 Judy Moss

13 Discoveries Unlimited Inc.

[illegible]

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